

UNITED STATES OF AMERICA

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DEPARTMENT OF LABOR

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EMPLOYEE BENEFIT SECURITY ADMINISTRATION
(EBSA)

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PUBLIC HEARING ON COMPUTER MODEL INVESTMENT
ADVICE FOR IRAs

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TUESDAY,
JULY 31, 2007

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The Hearing convened at 9:00 a.m.
in Room N-4437 of the Department of Labor,
200 Constitution Avenue, N.W., Washington,
D.C., Ivan L. Strasfeld presiding.

PRESENT:

IVAN L. STRASFELD, Director, Office of
Exemption Determinations, EBSA
CHARLES JACKSON, ESQ., Planned Benefit
Security Division, Office of the
Solicitor

ALAN LEBOWITZ, Deputy Assistant Secretary
for Program Operations

JOSEPH PIACENTINI, Director, Office of
Policy and Research

FRED WONG, Office of Regulations and
Interpretations

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P-R-O-C-E-E-D-I-N-G-S

9:36 a.m.

MR. STRASFELD: Good morning. My name is Ivan Strasfeld. I'm the Director of the Office of Exemption Determination, EBSA, U.S. Department of Labor. Under the Pension Protection Act of 2006, the Secretary of Labor is required to determine whether there was any computer model investment advice program meeting certain criteria described in the statute which may be utilized to provide investment advice to IRA beneficiaries.

On December 4, 2006, the Department published an RFI in the *Federal Register* to obtain, among other things, information regarding the operation of computer model investment advice programs regarding IRAs. The Department also solicited comments from certain trustees and other interested person. The purpose of this hearing is to receive additional public comments regarding computer model investment advice programs and their utilization by IRA beneficiaries.

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1 As to the procedures for this
2 hearing, we will follow the agenda that has
3 been prepared and previously made available
4 as provided for in the notice scheduling
5 this meeting. The speakers will be called
6 in the order listed. We ask that each
7 speaker attempt to stay within the allocated
8 15-minute period.

9 To the extent that members of the
10 panel have questions for the speakers, the
11 question and answer part of the testimony
12 will not count towards your 15-minute
13 presentation. We wish to note that nothing
14 should be read in the way questions may be
15 phrased and you should draw new inferences
16 as to the Department's views from the
17 question asked. At the conclusion of the
18 scheduled presentation, other comments will
19 be received if time permits.

20 If you have filed a written
21 statement with the Department, it is not
22 necessary to read the entire statement.
23 Rather speakers are encouraged to summarize
24 the statement in their oral testimony.
25 Prior to beginning your testimony, we ask

1 that you identify yourself, your affiliation
2 and the organization that you represent for
3 the reporter.

4 For those that wish to supplement
5 the record, this record for this proceeding
6 will be kept open until the close of
7 business on Friday, August 31st. The
8 official record of this proceeding will be
9 open for public inspection and copies will
10 be made available in our public disclosure
11 room which is in Room North 1513 in this
12 building.

13 I will now introduce other
14 members of the panel. To my left is Joe
15 Piacentini. He is the Director of the
16 Office Policy and Research. I've already
17 identified myself. To my immediate is Alan
18 Lebowitz, Deputy Assistant Secretary for
19 Program Operations. To his right is Fred
20 Wong, a member of the Office of Regulations
21 and Interpretations and to his right is
22 Charles Jackson, an attorney with Planned
23 Benefit Security Division of the Office of
24 the Solicitor.

25 All right. With that out of the

1 way, let the festivities begin. Our first,
2 Investment Company Institute, Mr. John
3 Breyfogle.

4 MR. BREYFOGLE: Can you hear me?

5 MR. STRASFELD: Yes.

6 MR. BREYFOGLE: Normally, I'd
7 like to say that we'd like you to follow the
8 most persuasive arguments. If you can't do
9 that because we think we're the most
10 persuasive, go with either the tallest
11 person or the first person. So we'll offer
12 any of those three interpretative principles
13 for you guys to follow.

14 (Laughter.)

15 MR. BREYFOGLE: My name is John
16 Breyfogle. I'm a partner with Groom Law
17 Group. I'm here representing the Investment
18 Company Institute. We appreciate the
19 opportunity to testify before you on the
20 feasibility of computer programs in the IRA
21 marketplace.

22 We have provided written
23 comments. I think Michael Hadley, he's the
24 Assistant General Counsel at the ICI, has
25 helped prepared. So I will attempt to

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1 summarize the highlights.

2 The interest of the Institute in
3 providing advice to IRAs is substantial.
4 Mutual funds are the investment vehicle of
5 choice for IRAs. Fund firms sponsor IRAs to
6 IRA investors as well as provide through
7 their affiliates a wide range of advisory,
8 management and other services. The ICI has
9 long supported legislation to foster
10 investment advice in the both the ERISA and
11 the IRA marketplace.

12 We think that the fundamental
13 goal of Congress in enacting the statutory
14 exemption was to increase the array, the
15 type of investment advice that was available
16 in both the ERISA marketplace and the IRA
17 marketplace. Obviously, the exemption
18 presents some pretty significant
19 interpretative challenges for the
20 Department. It's not the simplest or
21 cleanest exemption. So we appreciate the
22 challenge before you. But we do think that
23 the policy objective of encouraging
24 different types of and more flexible advice
25 in both of the marketplace, the 401(k)

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1 marketplace, the IRA marketplace, really
2 should guide your decision making. I do
3 want to thank you for the field assistance
4 bulletin that was issued at the beginning of
5 the year. That was a very helpful and quick
6 first step that confirmed several important
7 issues to the Institute's members.

8 The other thing I would commend
9 is sort of the Department proceed in
10 fleshing out this exemption on sort of two
11 track basis. One is obviously the
12 determination that you have to make under
13 the statute on feasibility, a prompt
14 decision, which we think should lead to a
15 class exemption process. We think that
16 would be the first track to go down.

17 The second track to go down is to
18 clarify as much through rulemaking the
19 general rules that are applicable under the
20 statutory exemption. We would like to see
21 if, at all possible, some enhancements to
22 the fee leveling rule beyond what was able
23 to be done in the FAB. We would also like
24 to see some enhancements in the computer
25 model universe, particularly to facilitate

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1 so-called off-model advice or advice after a
2 portfolio has been presented by a model. So
3 to really realize the Congressional policy
4 objective, we think two tracks is necessary
5 and we would appreciate your work in that
6 regard.

7 The issue before us is a very
8 important one, obviously. The IRA market is
9 an incredibly important market for the
10 retirement world. We have some data that's
11 been presented in our testimony. A couple
12 of things that were notable to us is that as
13 of the end of last year IRAs actually hold
14 more money than defined contribution plans.
15 So more retirement savings is now in IRAs.
16 \$4.2 trillion was held in IRAs at the end of
17 '06. Forty-two million households, more
18 than 42 million households, have IRAs.

19 Much of the growth in IRAs is
20 fueled by rollovers. Our data shows in '04
21 that over \$200 billion in rollover money
22 went into IRAs; whereas only about \$12
23 billion of new contributions went into IRAs.
24 So it's a very important area.

25 At the same time, the rules in

1 the IRA space are very different than the
2 ERISA rules in terms of, well, not really
3 rules, the available investment choices. As
4 you guys know well, in the typical defined
5 contribution plan, you have limited sets of
6 choices. Relatively few plans have
7 brokerage windows. Participants usually
8 pick among a dozen or somewhat more
9 investment choices that have been vetted by
10 plan fiduciaries.

11 In the IRA world, there are
12 virtually unlimited choices that
13 participants can go into and many IRA
14 sponsors including Institute members make
15 available the full range of choices that you
16 can get in through IRAs.

17 Our data shows that there is over
18 6,200 mutual funds available to IRAs. There
19 are over 5,000 publicly traded companies,
20 all of which offer a myriad of debt and
21 equity securities that are available to
22 IRAs. There are currency instruments,
23 foreign securities, futures, options,
24 insurance products, hedge funds, limited
25 partnerships. There are essentially very

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1 few things that an IRA investor cannot
2 invest in. Given the importance of IRAs as
3 a source of retirement savings and wealth,
4 given the wide range of choices, we think
5 it's sort of especially compelling for the
6 Department to look to ways to increase the
7 types of investment advice, the flexibility
8 of investment advice in that space.

9 In terms of the feasibility
10 determination that you all have to make
11 today, I'll just briefly recap what we think
12 are some of the relevant statutory
13 principles that should guide this decision.
14 Basically, through the PPA, there are sort
15 of two types of investment advisory programs
16 that are permissible. One is the so-called
17 Level Fees PACT that you've clarified
18 somewhat in the FAB. The other is the
19 computer model option. Computer models have
20 to meet certain statutory standards,
21 generally accepted investment theories, use
22 relevant participant information. They have
23 to be certified by an eligible investment
24 expert. Also as part of the statutory
25 exemption, the computer model has to take

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1 into account all of the investment options
2 under the plan. That's a specific statutory
3 requirement.

4 We think though that Congress
5 recognized that computer models may not be
6 suitable as defined in the statutory
7 exemption or even doable with respect to the
8 IRA market and obviously you were called on
9 to make this feasibility determination.
10 There's a variety of criteria that obviously
11 you know well that has to be applied in
12 making this determination. The one that we
13 think from an interpretative standpoint,
14 that's most important provision, is the
15 provision that says you have to find whether
16 any computer model can take into account the
17 full range of investments including equities
18 and bonds and if you can't make that
19 determination, you move into a class
20 exemption process that generally has to have
21 terms consistent with the statutory
22 exemption but without the computer modeling
23 condition.

24 So we think the critical question
25 is what did Congress mean when they directed

1 you to see if a model can take into account
2 the full range of investments including
3 equities and bonds. We do recognize there
4 are potentially different interpretations.
5 There is not necessarily one clear and sole
6 interpretation.

7 We do think though that the most
8 natural reading of the statute is that a
9 computer model has to consider, essentially
10 be able to consider, each potential IRA
11 investment and by that it would have to
12 include equities and bonds of which there
13 are literally thousands, all the mutual
14 funds available, as well as all the other
15 types of securities and non securities and
16 property that IRAs can invest in. We think
17 that's the natural reading of the statutory
18 directive.

19 There is no indication that
20 Congress contemplated that a computer model
21 would meet the statutory criteria if it
22 limited the universe of investments in
23 providing model advice and we just point out
24 that in adopting the condition to the
25 exemption Congress used words that were more

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1 limited, that the model have to take into
2 account what's available under the plan;
3 whereas the more expansive language for the
4 feasibility determination directs the
5 Department to make the finding with respect
6 to essentially the whole universe of
7 investments.

8 Assuming that the Department were
9 to agreed with that, and I don't assume
10 that, but then the question "Is there a
11 model out there that can do that?" The ICI
12 conducted a survey at the beginning of the
13 year of its members. Twenty members
14 responded. These members are the biggest
15 fund companies out there. They hold over
16 \$4.2 trillion in mutual fund assets. They
17 hold about 50 percent of the IRA mutual fund
18 assets and none of the members has a model
19 that has a capability to model that
20 universe.

21 Our recommended next steps would
22 be for the Department to promptly making the
23 finding that computer models aren't feasible
24 in the IRA applying this interpretation of
25 the statute and looking at the record that's

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1 being submitted to it and, at that point, we
2 think it should promptly move to the class
3 exemption process where we believe you
4 should seek to promote both models that may
5 model a limited universe as well as advisory
6 programs that are not model driven. We
7 don't think an exemption should be biased to
8 one or another method of providing this
9 important service to this space. We think
10 the key conditions would be obviously IRA
11 holder consent and robust disclosure.

12 So with that, I'm going to stop a
13 little bit early. I'll take any questions
14 that you have at this point. Thank you.

15 MR. LEBOWITZ: John, this whole
16 debate is really about what that phrase
17 "full range of investments" means, isn't it?

18 MR. BREYFOGLE: Yes, absolutely.

19 MR. LEBOWITZ: So if we were to
20 conclude that it means "asset classes" and
21 not the full range of every conceivable
22 investment, what do you think the answer
23 would be to the core question here as to
24 whether such a program, computer model
25 program exists?

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1 MR. BREYFOGLE: The other
2 criteria of objectivity and things like
3 that, I think most of the commentators suggest
4 it could be met, could be satisfied. It's
5 really this is the key interpret question
6 that I think has to be resolved. So I do
7 think there are objective models. I do
8 think there are models that can provide
9 advice and can be generally accepted, all
10 the other criteria. So I really do think
11 this is the nut.

12 MR. LEBOWITZ: Right. So am I
13 understanding you correctly? If our
14 conclusion is that our interpretation of the
15 statute is that the full range contrary to
16 your view is referring to asset classes,
17 then the answer to the question that
18 Congress posed to us is whether such a
19 program exists would be yes.

20 MR. BREYFOGLE: I think you'd
21 have to -- I haven't looked at whether each
22 of the other criteria can be met and that
23 hasn't been the focus. Assuming you could
24 make the determinations on all the other
25 criteria, I think the answer would likely be

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1 yes. I don't think that's what Congress
2 meant through the inclusion of this
3 provision though and I think the fact that
4 the statute uses words of limitation and the
5 exemption condition uses deliberately
6 expansive language here without words of
7 limitation, having been involved in the
8 process at the time and having some
9 understanding of what was being thought at
10 the time, I actually don't agree that that's
11 the right interpretative answer. But I do
12 think that the Department has flexibility to
13 interpret this provision and it wouldn't be
14 outside of that statute if you reached that
15 conclusion. But I do think that it would
16 drive you down a set of solutions that would
17 be necessarily less flexible than the kinds
18 of solutions that we would like to see in
19 the IRA space that we think that you might
20 be able to get there through an exemption
21 process.

22 MR. LEBOWITZ: The exemption, at
23 least the provisions in the statute that we
24 would be directed to adopt, seeing at least
25 that first reading now you seem to have a

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1 different --

2 MR. BREYFOGLE: I do. I don't
3 think -- I mean, I think obviously this
4 whole exemption is poorly framed. The
5 feasibility provision which was tacked on
6 in conference in the last few days is also
7 poorly framed. But I think if you work
8 through it, basically it's telling you the
9 class exemption consistent with the statute
10 but without the computer model condition.

11 So what does that tell you to do?
12 You could read it literally and say, "We
13 have to issue a class exemption that has a
14 fee leveling condition in it" because that
15 would be consistent with the statute. But
16 that would be utterly inconsistent with the
17 purpose of having to go to the class
18 exemption process.

19 I basically think that what
20 they're directing you to do is to get into
21 the exemption process and the Department has
22 fairly wide latitude in what it can do. It
23 should obviously adopt the types of
24 disclosure conditions, presumably some form
25 of a workable audit rule, some provision

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1 that requires obviously IRA holder consent.
2 The exemption wouldn't be consistent if it
3 covered discretionary products. So there
4 are other things that you can do.

5 I don't think that the
6 Department's latitude once it gets into the
7 exemption process though would be all that
8 limited. I think you could both foster
9 personalized advice that's not driven by a
10 model or maybe it starts with a model and
11 then gets to specific recommendations as
12 well as model advice that has the limited
13 universe. I think both of those should be
14 considered and pursued in the exemption
15 process.

16 MR. LEBOWITZ: We could do that
17 anyhow if we wanted.

18 MR. BREYFOGLE: There's the
19 right.

20 MR. LEBOWITZ: It's a policy
21 judgment, too, to go down that road.

22 MR. BREYFOGLE: Right. The
23 Department, I think, outside of this
24 directive could just pursue its own class
25 exemption that quite frankly is a more

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1 workable and sensible one than what was put
2 together in the PPA conference. Absolutely,
3 there is general authority under 408 to do
4 that.

5 MR. LEBOWITZ: Is that what you
6 meant by -- You said during your testimony
7 you used the word "enhancements." Is that
8 what you were getting at?

9 MR. BREYFOGLE: I was getting at
10 that the Department really should attack
11 this problem on a two track basis. One is
12 through the rulemaking process in
13 interpreting the actual statutory exemption
14 to the extent possible to give us more
15 flexibility on the level fee's approach as
16 well as the computer model approach as well
17 as pursue the class exemption process. So
18 in terms of how I used "enhancement," I'm
19 not remembering exactly how, but was it in
20 connection with talking about the rulemaking
21 or the exemption?

22 MR. LEBOWITZ: I think you were
23 talking about the actions the Department had
24 taken up to this point.

25 MR. BREYFOGLE: Yes.

1 MR. LEBOWITZ: And then you
2 talked about your view that there was a need
3 for some enhancements in some respects.

4 MR. BREYFOGLE: What I was saying
5 there was obviously I thought the field
6 assistant's bulletin was a very good quick
7 step to just solidify everybody's
8 understanding about the Frost Bank approach,
9 about the SunAmerica approach, about duties
10 and liability of fiduciaries.

11 The fee leveling guidance while
12 we think was helpful, we think could be
13 improved possibly by rulemaking so that the
14 level fee rule only applies to the person
15 giving the advice. That was something we
16 had suggested to the Department prior to the
17 FAB. Additionally, we thought that there
18 was some clarifications on the computer
19 model front that would be enhancements as
20 well.

21 MR. STRASFELD: Let me ask you a
22 question about to the extent we can't make
23 the findings or the determination and we
24 have to proceed along a class exemption
25 track the language that the instructions we

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1 were at the Department given was that we
2 have to ensure that the requirements of the
3 statutory exemption were met other than the
4 computer model and then the other provision
5 was we have to ensure that investment advice
6 is provided under a program that utilizes
7 prescribed objective criteria to provide
8 asset allocation portfolios comprised of
9 securities or other property available as
10 investments under the plan.

11 MR. BREYFOGLE: Yes.

12 MR. STRASFELD: I read that as
13 being somewhat of a narrowing of the
14 authority for us to grant an exemption
15 pursuant to the statutory exemption. As
16 Alan mentioned, we obviously have the
17 authority consistent with our findings to
18 provide relief outside of this context. But
19 I would like any comments on what you think
20 that statement means.

21 MR. BREYFOGLE: On the latter
22 statement, I think that there is a way to
23 reconcile that which is obviously they're
24 telling you you can't do a computer model.
25 So we can't just read to mean a computer

1 model.

2 MR. STRASFELD: Right.

3 MR. BREYFOGLE: The way most
4 advice products get delivered is in the sort
5 of personalized, one-on-one advice setting
6 is an individual advisor is going to sit
7 with you. You're going to fill out a
8 questionnaire. They're going to get a risk
9 profile, risk tolerances. They're going to
10 look at all your assets. Most programs,
11 they will come up with some basic asset
12 allocation strategy that will be
13 quantitative and model driven and from that
14 spot, they're going to populate it with
15 specific securities and property
16 recommendations.

17 So to get to your point, how
18 could you satisfy the condition and still
19 get to the flexibility that we want and, I
20 think, need given the sort of dizzying array
21 of choices that are available to IRA holders
22 one is that you require that people do that
23 kind of questionnaire, do that kind of
24 profile, make sure there is an asset
25 allocation strategy in place and then give

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1 recommendations that are not model driven
2 that are consistent with that kind of
3 objective, overarching asset allocation
4 strategy and I think that would be a way to
5 reconcile the statute. It would be a good,
6 sort of protective condition and also add a
7 lot more flexibility and also work fairly
8 consistently with products that are actually
9 delivered in the non-ERISA, non-IRA world.

10 MR. STRASFELD: So would you view
11 this requirement as being met if there is
12 some objectivity in the presentation by the
13 registered rep in terms of asset classes
14 and, as you indicated, then it's populated
15 with particular products although there
16 would be some limitation on the advice
17 provider?

18 MR. BREYFOGLE: I don't think
19 there would be any limitation on what you
20 could recommend.

21 MR. STRASFELD: Sure.

22 MR. BREYFOGLE: But it would have
23 to be consistent with an overall objective
24 allocation strategy.

25 MR. STRASFELD: Right.

1 Following, how would that work exactly? I'm
2 interested as to what this individual would
3 have before them in making their advice,
4 providing their advice, to the IRA
5 participant. I assume from reading this
6 language it would suggest that he just can't
7 do whatever he wants. There is some
8 limitation on him.

9 MR. BREYFOGLE: Right.

10 MR. STRASFELD: What is that?

11 MR. BREYFOGLE: And I think it's
12 a misnomer to think that that's really what
13 happens in a marketplace. People don't just
14 do whatever they want or just say, "Hey, I
15 want to put you 100 percent in this."

16 MR. STRASFELD: Right.

17 MR. BREYFOGLE: People really do
18 start with an objective, data-driven process
19 of questionnaires and putting together a
20 sense of your risk tolerance, understanding
21 what your portfolio as a whole is and then
22 coming up with an allocation scheme and
23 trying to populate it with specific
24 securities recommendations.

25 MR. STRASFELD: Right.

1 MR. BREYFOGLE: And to me, that's
2 entirely consistent with the statute to say
3 that there are some steps you have to get to
4 before you can give specific non-model
5 driven advice. I don't think it's all that
6 inconsistent with what people do and I think
7 it would be a way to satisfy the objectivity
8 criteria. Obviously, these are issues that
9 we would, the Institute would, want to do
10 some policy making and process and make
11 recommendations of the course of the class
12 exemption process with the Department to
13 choose that pathways.

14 MR. STRASFELD: Okay. Any other
15 questions? Thank you very much.

16 MR. BREYFOGLE: Okay. Remember
17 tallest and first.

18 MR. STRASFELD: I remember that.

19 (Laughter.)

20 MR. LEBOWITZ: How tall are you
21 John?

22 MR. BREYFOGLE: Six foot five.

23 MR. LEBOWITZ: Put that in the
24 record.

25 MR. BREYFOGLE: I'll be taller if

1 anybody else is 6'5".

2 (Laughter.)

3 MR. STRASFELD: All right.

4 Financial Engines.

5 MR. FINE: I'm Financial Engines.

6 I'm not 6'5". And I'm not first, but I'm
7 going to testify.

8 My name is Ken Fine. I am the
9 Executive Vice President of Marketing for
10 Financial Engines. My job and the job of my
11 team at Financial Engines is to define how
12 our products and services work and to design
13 how we communicate the output of those
14 products and services to individual
15 investors.

16 I've been with the company for
17 about ten years and have led the development
18 of all of our products and services since
19 the company was founded. I have with me two
20 colleagues who will be available to answer
21 questions on methodology and legal issues,
22 our Vice President of Portfolio Management,
23 Sylvia Kwan, and our General Counsel, Anne
24 Tuttle.

25 In terms of our testimony here

1 today, we recognize you already have a deep
2 understanding of the IRA market. As such,
3 I'm going to focus my comments almost
4 exclusively on the specific question at hand
5 which is is it feasible to provide
6 investment advice to IRAs using a computer
7 model.

8 I'm going to go through that in
9 four basic steps. I'll give a quick outline
10 of financial engines in our history. Then
11 I'll talk about our specific experience
12 actually providing investment advice on IRAs
13 using a computer model. Then I'll move onto
14 our methodology, how we actually go about
15 doing so. Then I'll end with summary and
16 recommendations.

17 In terms of corporate background,
18 we were founded in 1996 by Bill Sharpe.
19 Bill won the Nobel Prize in 1990 for his
20 work in contributing a modern portfolio
21 theory. The basic idea behind the company
22 was to take the work he had done over the
23 previous two decades with pension funds and
24 in academia and bring that to bear on the
25 problems of the individual investor.

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1 The primary business that we're
2 in providing investment advise and
3 investment management to 401(k) accounts of
4 employees of Fortune 500 companies. So
5 that's primarily what we do. To put that
6 into perspective, as of June 30th, 106 of
7 Fortune 500 have hired us to provide advice
8 to their participants covering about 6.5
9 million participants. That gives you a
10 sense for the scope of our business.

11 In terms of the services that we
12 provide, there are two, investment advice
13 and investment management. The difference
14 between the two, on the advice side, we
15 provide recommendations that people then
16 decide to implement. On the management
17 side, we actually execute the trades and
18 manage the portfolio.

19 The technology that drives these
20 services which would be very relevant to the
21 discussion of the computer model are also
22 twofold. We have a forecasting technology
23 which uses Monte Carlo simulation which
24 essentially provides a range of outputs
25 which shows how much someone's account might

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1 be worth in the future, so a range of
2 possible outcomes, good, bad and in the
3 middle.

4 The second technology is our
5 optimization technology and that technology
6 essentially selects portfolios with the
7 highest expected return for a given level of
8 investment risk. So that's a quick
9 background on who we are and what we do.

10 Transitioning to our experience
11 specifically with IRAs, in 2001, we rolled
12 enhancements to our services that enabled us
13 to provide investment advice across all tax
14 deferred and taxable accounts. To be
15 specific that includes 401(k), 403(b), IRAs,
16 Roth IRAs, SEP as well as taxable brokerage
17 accounts. So that was in 2001. We've been
18 doing this for approximately six years.

19 Those services are available in
20 several different locations. They're
21 available today on FinancialEngines.com.
22 They're also distributed and accessible
23 through Vanguard, City Street and American
24 Century. In addition, some of our corporate
25 customers have elected to make investment

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1 advice on IRAs available along sign
2 investment advice on 401(k)s, so the IRAs
3 with the 401(k) and then also have us
4 provide investment advice on IRAs for those
5 who want to take advantage of that service.
6 We've been doing that for about six years.

7 In terms of total scope, we have
8 provided investment advice on IRAs to
9 approximately 30,000 individual investors
10 covering about 50,000 IRA accounts and \$4
11 billion in assets. That's the IRA-specific
12 advice.

13 Now moving onto how we do and
14 what we do, in terms of providing advice on
15 an IRA with a computer model, five key
16 points. The first is that the business
17 itself and the models we have developed are
18 independent, meaning we do not derive -- our
19 revenue is not influenced by or impacted by
20 the advice that we give. One hundred
21 percent of our revenues come from our advice
22 and management. We do not collect
23 commissions, top dollar payments,
24 12(b)(1) fees or really any revenue related
25 to the sale of investments. So that's an

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1 overarching umbrella across all of our
2 methodology.

3 In terms of interacting with the
4 individual investor, the process begins with
5 gathering information and we break that
6 information gathering process into two
7 different levels. There is the minimum
8 information that we consider necessary to
9 begin the advisory experience and then there
10 is additional and substantial optional
11 information that someone can provide to
12 enhance that experience and make the
13 investment advice more personalized.

14 The minimum information required
15 is at date of birth investment horizon and
16 the specifications on the investment
17 universe that the person can invest in, we
18 usually get that information from the
19 financial institution and I'll speak more on
20 those details in a moment.

21 Optional additional information
22 that the investor can provide includes
23 information on all other accounts. So, for
24 example, if the individual would like advice
25 on their IRA but wants that in the context

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1 of their 401(k), another IRA and a taxable
2 brokerage account, that information can be
3 provided on a specific investment level.
4 Risk preference. Other sources of income,
5 pensions, Social Security, etc., salary,
6 financial goals and the contribution rates
7 into the various accounts. So that
8 constitutes the additional information
9 people can provide that enhances the total
10 advisory experience.

11 Once that information is
12 provided, we then provide the individual
13 investor with two deliverables, if you will.
14 The first is a forecast of how much that IRA
15 account and any other accounts that they've
16 told us about might be worth in the future.
17 So we use Monte Carlo simulation at the
18 specific investment level and forecast what
19 that set of investments might be worth in
20 the future. Then we provide specific advice
21 which includes buy and sell recommendations
22 on the investments and the investment
23 choices and options available in the IRA
24 account.

25 With respect to asset coverage in

1 the investment universe that is available
2 when using a computer model, that universe
3 is as follows. We can provide advice across
4 all mutual funds. That includes equity,
5 fixed income, actively managed and passively
6 managed, across any size universe. It could
7 be ten funds or 10,000 funds. The model
8 could handle any size. Exchanged Traded
9 Funds, ETFs. Institutional and co-mingled
10 fund products. Individual stocks. Baskets
11 of stocks. Separate accounts. Stable value
12 and cash investments. So any of those
13 products or assets classes can be in the
14 investment universe as part of what the
15 individual is getting forecast on and
16 receiving advice on.

17 With respect to bonds, we provide
18 simulation of individual bond positions,
19 meaning we'll take a bond or a set of bonds
20 and simulate how much those might be worth
21 in the future. Today we do not provide
22 advice across bonds. If that was something
23 we wanted to do, it is a straightforward
24 extension of our current methodology. It's
25 something we have not yet taken on.

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1 If the individual would like to
2 include assets in his or her total picture
3 that I haven't mentioned, then there is the
4 option to define something or enter
5 something called a user defined asset where
6 the individual can or the advisor can put in
7 assets, specify the size of that investment
8 and the expected growth rate in the future.

9 Once the advice has been
10 provided, the individual has the ability to
11 personalize that advice. For example, let's
12 say the advice was to invest 25 percent of
13 the IRA account in a particular
14 international equity fund. If the
15 individual received that advice and decided
16 he or she wanted to invest, let's say, 30
17 percent, that person could change the
18 recommendation, lock in 30 percent. The
19 computer model would then do the best that
20 it could with the remaining 70 percent given
21 the investment universe and try to diverse
22 any additional risk which has been taken on
23 with that additional allocation.

24 Wrapping up, three key points.
25 It is possible to provide high quality

1 investment advice on IRAs using a computer
2 model. We've been doing that for about six
3 years. With respect to regulatory and
4 providing guidance on this activity, it's
5 our opinion that if the advisor that's
6 providing the advice does have a conflict of
7 interest and has interest in the products
8 that are being advised across, that it's
9 vital the model be unbiased in its
10 recommendations.

11 In terms of what does unbiased
12 really mean or how might you check or verify
13 that a model is unbiased, first, the
14 recommendation should be unaffected by the
15 identity of the investment manager or any
16 revenue implications to the advisor and we
17 believe the heart of where we would look if
18 we were looking at the model to check how
19 biased or unbiased it was, we would look at
20 how it accounts for fees. So our fees are
21 explicitly accounted for in the model and
22 how. In terms of then providing guidance,
23 we believe that the framework, the PPA for
24 401(k), would be suitable in the context of
25 an IRA and would suggest that it be clear

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1 that this applies to advisors that do have a
2 conflict, not those that do not.

3 Those are my prepared comments.
4 I could take questions.

5 MR. LEBOWITZ: So your -- Well,
6 in your written submission to us, your
7 answer to what we talked about earlier is
8 the core question whether a program exists
9 within the framework laid out in the
10 statute was very simple and you said yes and
11 went on to describe your company's approach
12 to it. Am I right that you're saying that
13 however the full range of investments is
14 defined, your program, your product, is
15 capable of modeling almost without
16 limitation?

17 MR. FINE: I'd say, sir, our
18 program is capable of modeling sets of
19 investments that I specified and included in
20 the written testimony which is a large
21 portion of the investment universe. Our
22 experience is, obviously as a company, we
23 provide advice through a computer model,
24 that's what we do, whether it's 401(k),
25 IRAs, whether we're using those models for

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1 management in addition to advice, is that
2 there are certain levels of investment,
3 certain levels of breadth of investment
4 universe that's appropriate for certain
5 investors.

6 So, for example, we do not
7 provide investment advice on calls and puts.
8 That's not something we do in our model and
9 we believe that there's a market for people
10 who do that and it can be done in other
11 ways. Our experience is that the investment
12 universe that we do offer advice over is
13 appropriate for an IRA for the vast majority
14 of people who invest in IRAs/

15 MR. LEBOWITZ: Do you think that
16 Congress intended that the advice that the
17 computer model in the IRA context takes into
18 account options?

19 MR. FINE: Well, I don't know
20 what Congress intended, but I would not
21 expect that that would be considered a
22 typical investment with an IRA for most
23 people.

24 MR. LEBOWITZ: And do you have a
25 view on the interpretative issue that we're

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1 grappling with here on what Congress
2 intended in the context of this phrase "full
3 range of investments"?

4 MR. FINE: Yes. Our
5 interpretation is that it would be a range
6 of investments that's consistent with what
7 the typical investor invests which could
8 include mutual funds, stocks and bonds. So
9 it would not be an exhaustive list of every
10 possible single instrument that anyone could
11 ever invest in. Rather it's the majority of
12 investments that people do invest in.

13 MR. LEBOWITZ: Thank you.

14 MR. STRASFELD: I have a quick
15 question. All right. One of the major
16 distinctions between IRAs and 401(k) plans
17 is in 401(k) plans you, the participant, are
18 limited to the options available under the
19 plan and when you get to the computer model
20 for 401(k) plans, it specifically describes
21 it as such that you have to be able to model
22 everything offered.

23 I just want some practical
24 guidance in the IRA context. In a lot of
25 these you can sort of invest in whatever you

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1 want even down to an open brokerage window.
2 So how does your process begin. Let's
3 assume in some of these cases the IRA
4 participant or beneficiary may come to you
5 with an idea in mind. He wants to invest in
6 a family of mutual funds. But what about
7 the situation where the participant is not
8 particularly knowledgeable and just comes to
9 you and says, "I basically want to go with
10 the full range in order to increase my
11 diversification and limit my risk"? How do
12 you go about the process of actually
13 selecting what's in there? Who actually in
14 the context of IRAs picks the investment
15 universe?

16 MR. FINE: There are really two
17 different ways that that process can work,
18 at least, the way that we deliver our
19 services. The first is what -- The
20 distinction is whether it's delivered
21 through an advisor, so an advisor using our
22 computer model or an individual investor
23 using our computer model on their own.

24 So let's say in the case of an
25 advisor. We would generally work with the

1 advisor to determine what universes do you
2 want to make available in your business.
3 One universe could be all retail funds. It
4 could be a particular family. It could be
5 groups of families. It could be basically
6 any universe they would define and they
7 would include that in their up-front
8 discussion with the individual investor
9 saying "Here are the different options" or
10 even in some cases, create sets of advice
11 based on different universes and compare
12 them, saying "Here's what we can do with
13 Universe A. Here's what I can do for you
14 with Universe B and then here's how that
15 affects your retirement picture." So that
16 would be an advisor-driven experience.

17 In the case of where an
18 individual is working, interacting, with the
19 service, it's similar that the individual
20 makes that selection. So what we've done,
21 for example, in our service is we've created
22 a menu of common universes and fund families
23 that people can invest in and we've done
24 research to identify that those universes
25 cover well north of 90, 95, percent of what

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1 people do invest in. So we've done some
2 market research and people essentially
3 select the universe they think is
4 appropriate for them or they could select
5 all. We basically look at all the different
6 universes and we optimize across those
7 universes.

8 MR. STRASFELD: What have you
9 seen the vast majority of people selecting?
10 I mean, do they go for a huge universe or
11 families of mutual funds? Is there
12 something that's typical?

13 MR. FINE: It's a good question.
14 I don't have data, but my experience has
15 been that people left to their own devices
16 choose the universes associated with the
17 provider of their IRA. So if their provider
18 is financial institution A, they will look
19 on the list for that institution and we have
20 done research to make sure that we've
21 included the investments for that
22 institution. They'll pick that one. If
23 they're shopping around and thinking about
24 switching from financial institution A to B,
25 then they might put both or they might put

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1 the other one. That's usually the basis
2 they use to make their decision or they
3 might default to everything. That's usually
4 the case.

5 MR. STRASFELD: Thank you. Any
6 other questions?

7 MR. PIACENTINI: I do.

8 MR. STRASFELD: Good.

9 MR. PIACENTINI: Early in your
10 testimony, you said that there's a minimum
11 list of factors that ought to be considered
12 in a model, date of birth, investment
13 horizon, investment universe, and then there
14 are other factors that might also be
15 considered. If advice is provided on just
16 the minimum versus advice provided on all of
17 the factors, how different does the advice
18 turn out to be?

19 MR. FINE: Good question. So the
20 way our classes work since we use simulation
21 as a basis for the advisory experience as
22 opposed to a questionnaire that provides
23 generally a more hypothetical set of
24 questions around what your preferences are,
25 what we would do, and I'll walk through

1 briefly a typical experience and make it
2 very tangible, let's say you were
3 interacting with a service either directly
4 or you were talking to an advisor and you
5 had an IRA account with a certain financial
6 institution, we would start by gathering
7 that information often electronically if
8 it's there in a recordkeeper and provide a
9 forecast of that and say, "Here's your
10 starting point. You have an account and
11 here's how it might turn out in the future."

12 The next step would be "Would you
13 like to get advice across this same universe
14 or would you like to look at another
15 universe?" And when we move to that step,
16 then we would show someone two things. We
17 would say "If you would like to maintain the
18 same level of investment risk that you have
19 today, here's what we could do that's a
20 little bit better." So it reflects the
21 types of decision making you've already
22 done, but it's a bit more of efficient
23 portfolio.

24 Then we would provide an ex-
25 portfolio which is if you would like to

1 compare that to what people typically do
2 with your investment horizon. Here's how
3 that looks. That's the experience we can
4 provide with the minimum information. So
5 here's your current situation and here's how
6 you could do it with a couple different
7 levels of risk.

8 At that point, the individual has
9 the opportunity to interact and add more and
10 say, "Well, I appreciate those starting
11 points, but I'd actually like to explore yet
12 another risk level. I would like to see
13 what things look like if I've very
14 conservative or very risky or now I'd like
15 to add in my 401(k) account and see how that
16 affects the advice." So we start with what
17 we have, basically two different risk
18 levels, and then we start to expand the
19 picture based on whatever other information
20 the investor wants to provide.

21 MR. PIACENTINI: I guess where I
22 was trying to focus was if you additionally
23 take into account the 401(k) account or some
24 other source of income, for example, from a
25 spouse. Is there the potential that the

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1 advice would change a lot?

2 MR. FINE: Absolute. Yes.

3 Certainly. So we do look at the interaction
4 of covariances between the specific
5 investment products in the different
6 accounts. So if someone, for example, were
7 to tell us about a brokerage account that
8 had very high risk stocks, that would affect
9 the recommended allocations within the IRA.
10 Yes, it would.

11 MR. PIACENTINI: And you said
12 that your model employs optimization to
13 maximize return for level of risk.

14 MR. FINE: Yes.

15 MR. PIACENTINI: Does it do that
16 with respect to the investment horizon or
17 with respect to the nearest period?

18 MR. FINE: That would be a good
19 question for Sylvia.

20 MS. KWAN: Yes. What Ken was
21 talking about as sort of the initial is
22 driven by investment horizon. So depending
23 upon the investment horizon, we get someone
24 at a particular level of risk and once
25 they've seen the forecast and all the

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1 outcomes, they can then change that level of
2 risk to what they desire. So the starting
3 point is based on investment risk.

4 MR. PIACENTINI: Okay. Last
5 question. You said in terms of evaluating
6 unbiasedness the first place you would focus
7 this on is the treatment of fees.

8 MR. FINE: Yes.

9 MR. PIACENTINI: So I guess my
10 question is can that be summed up as returns
11 ought to be treated as net of all fees and
12 expenses or is there something more to it
13 than that?

14 MR. FINE: I think that's my
15 interpretation. Sylvia, could you address
16 that?

17 MS. KWAN: Sorry.

18 MR. FINE: What's the most
19 appropriate way to include fees in the
20 model? Is it simply saying returns or net
21 of fees?

22 MS. KWAN: Yes.

23 MR. PIACENTINI: Thank you.

24 MR. STRASFELD: Thank you very
25 much.

1 MR. LACKRITZ: Good morning. May
2 it please the court. Good morning. It's a
3 pleasure to be here and an honor to be able
4 to testify to you about this issue.

5 My name is Mark Lackritz. I'm
6 the President and Chief Executive Officer of
7 the Securities Industry and Financial
8 Markets Association. We're a trade
9 association of over 650 securities firms,
10 banks and asset managers both locally, in
11 the United States and globally. We operate
12 through offices in New York, Washington,
13 London and Hong Kong and our members
14 represent about 95 percent of the overall
15 securities industry and financial markets'
16 activity going on in this country.

17 Our diverse members provide a
18 vast array of financial products and
19 services to investors from all different
20 walks of life including custodial, brokerage
21 and advice services, in this case, to more
22 than 13 million IRA accounts. I'm here in
23 that capacity as the president and CEO of a
24 trade group but also in the capacity of
25 somebody that just announced yesterday that

1 he has plans to retire in the near future.
2 So I am here as a user of these services as
3 well and I'm also a father of three adult
4 daughters, each of whom have their own IRA
5 accounts and none of whom have found any
6 computer models to be anywhere close to
7 being satisfactory for providing investment
8 advice. Enough about my personal
9 experience, but I think that's relevant in
10 terms of what we're talking about here.

11 We don't believe that a computer
12 model that would meet the statutory
13 requirements of the Pension Protection Act
14 is either effective or feasible and we urge
15 the Department to make that finding and to
16 issue a disclosure-based exemption for the
17 provision of investment advice for IRAs.

18 I would just like to give you a
19 broad overview of why this is the case.
20 First of all, investors and beneficiaries
21 deserve clear, understandable, relevant and
22 customized investment advice so they can
23 make decisions that are tailored to their
24 own personal circumstances. They should
25 have robust choices when making financial

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1 decisions and shouldn't be forced into a
2 one-size-fits-all approach of a computer
3 model that simply cannot offer the level of
4 service an investment advisor can. Maybe
5 someday we'll get to that point where
6 technology and computer are going to be able
7 to do that but we're clearly not at that
8 point now.

9 Investment advice encompasses
10 much more than existing computer models
11 provide. In a key survey of mutual fund
12 investors, nearly two-thirds of shareholders
13 identified asset allocation as only one of
14 five distinct difference services that they
15 received from their advisors. They also
16 identified financial planning assistance,
17 retirement assessment management and
18 specific investment recommendations as
19 services that were regularly provided in
20 these advisory relationships. Investors
21 that have used a professional financial
22 advisor say that they have done everything
23 they can to financial prepare and they feel
24 more comfortable with their knowledge and
25 involvement of saving for retirement than

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1 those who don't or have not.

2 A recent Forrester survey
3 concluded that for every single generation
4 independent financial advisors and financial
5 advisors at brokerages "are at the top of
6 the list of most helpful resources for
7 retirement research." Consumers that have
8 used the internet to research retirement put
9 the channel right behind human advisors in
10 terms of helpfulness. That's
11 understandable.

12 We don't ask you to get medical
13 advice from a model. We don't mandate that
14 you get medical advice from a model. Is it
15 feasible? I suspect it might be feasible.
16 Does it make any sense? Absolutely not. Do
17 we do the same thing with legal advice or
18 regulatory advice? Of course, we could get
19 models here, but do we want to mandate that?
20 I don't think so.

21 Consumers who have used the
22 internet to research retirement put the
23 channel behind advisors in terms of
24 helpfulness and online solutions or other
25 web-based guidance programs really aren't

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1 good enough yet to attract more than a
2 fraction of the population. You just heard
3 the previous speaker talk about serving
4 30,000 accounts. I think that's terrific.
5 We're talking about millions and millions
6 and millions of accounts here. We're
7 talking about IRA assets that in the next
8 ten years are going to grow to about \$10
9 trillion.

10 Just to harken back to earlier
11 era, a trillion here, a trillion there, it's
12 real money. This is significant and this is
13 an important economic asset in the long run.
14 In addition, those who are most likely to
15 use the internet to plan for retirement are
16 the least confident in their ability to
17 estimate when they'll retire, how much it
18 will cost and where the money will come
19 from.

20 I guess I'd like to focus on a
21 couple different points. One is the statute
22 itself. I mean, let's just talk
23 specifically about the question that you
24 raised before, Mr. Lebowitz, because I think
25 it's exactly the relevant question here.

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1 IRAs may invest in stocks, bonds, CDs,
2 mutual funds, annuities, real estate,
3 limited partnerships and private stock, both
4 foreign and domestic and futures and
5 options. There are no limitations here and
6 the statute specifically talks about, takes
7 into account, the full range of investments
8 including equities and bonds. That's not
9 classes of assets. That's specifically
10 referred to in the previous section. If
11 we're talking about classes of assets, this
12 section wouldn't be necessary. You could
13 just refer back to that other section.

14 It also determines the options
15 for the investor portfolio of the account
16 beneficiary. It also allows the account
17 beneficiary to direct the investment of
18 assets and have sufficient flexibility in
19 obtaining advice to evaluate and select
20 investment options. That's not just mutual
21 funds. That's just not an allocation of
22 mutual funds and within equities and bonds,
23 as you all well know, there are all kinds of
24 different categories. Is it value? Is it
25 growth? Is it large cap? Is it small cap?

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1 Is it high risk? Which sector is it in,
2 etc.?

3 Now obviously technology is doing
4 things we couldn't have imagined 20 years
5 ago and I suspect 20 years from today it
6 will be doing things we can't even imagine
7 today. One of them may well be to level of
8 sophistication to actually interact on a
9 one-to-one basis and, in fact, provide
10 specific kinds of advice with respect to
11 specific kinds of investments that are
12 permitted to an IRA account holder. But I
13 would suggest to you that right now
14 technically that's not feasible as even was
15 admitted before by the Financial Engines'
16 witness who said yes, they had provided
17 investment advice for a broad, for a
18 majority, or I forget the word he used, but
19 it wasn't a full range of investment
20 options. It wasn't there. It's not here.

21 And therefore, what do you do?
22 We'd like you to issue an exemption, a
23 broad-based exemption, that provides for
24 audit compliance at high level so that you,
25 in fact, provide for audit at the level of

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1 policies and procedures utilized by these
2 providers and that would make it simple,
3 that would make it effective, and that would
4 provide the investment advice that millions,
5 literally millions, of IRA account holders
6 really want.

7 I mentioned my daughters earlier
8 because I think that's exactly the group
9 we're talking about, people in their 20s
10 just starting out, beginning to save money
11 for long term, looking around for serious
12 investment advice. There's a whole
13 profession that provides this and we think
14 of investment advice and financial advice,
15 obviously, in very serious terms, just as
16 seriously as we think of medical advice or
17 legal advice or other kinds of professional
18 advice out there.

19 So I would strongly suggest that
20 what we need here is a broad-based exemption
21 and from the standpoint of compliance, it
22 should be at a very high level so that we're
23 not getting into the weeds and making it so
24 costly and burdensome and creating
25 additional liabilities so that in fact we

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1 end up clogging the system and we don't get
2 the deliverables that actually the IRA
3 beneficiaries clearly want and clearly need.
4 I wanted to state that as clearly as I
5 could.

6 I guess the other point I wanted
7 to make was I thought that Congress -- It
8 seems to me looking, reviewing, the statute
9 Congress was extremely clear here. Unless
10 computer models can take into account all
11 potential investments of an IRA including
12 what I've talked about before, the statutory
13 exemption for computer models cannot be used
14 and the Department of Labor must issue a non
15 computer, model-based exemption. Nobody has
16 testified that a computer model has been
17 developed and the development will clearly
18 be hampered by extraordinary cost and the
19 need for computer capacity which will make
20 the use of these models for IRAs
21 prohibitively expensive.

22 Just taking a count of what's
23 already held by an IRA in computer model is
24 not providing investment advice. That's not
25 -- You know, yes. I can say "What does this

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1 look like in a Monte Carlo simulation?"

2 "Well, it looks good." "It looks bad."

3 "Well, I don't know what that means. Does

4 that mean I should change? If I should

5 change, does that mean I should sell

6 Microsoft and I should invest in Google?

7 Does it mean I should short Google options

8 and invest in a swap or a caption or

9 something like that?"

10 I appreciate that technology has
11 an enormous capacity here. I'm not -- We're
12 not being Luddites. Our members all use and
13 have taken advantage of a great deal of
14 technology. It's opened up avenues and
15 options and opportunities that nobody deemed
16 feasible recently.

17 But we're not to the point of
18 providing this kind of advice for IRA
19 holders on a wide basis. So it seems to me
20 from the statutory history, from the
21 technology that's currently available, from
22 the evidence you have on the record that you
23 really should come to the conclusion that
24 these are not feasible from the standpoint
25 of providing investment advice to IRA

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1 account holders and you should proceed to
2 issue a broad-based exemption with an audit
3 requirement at a high level.

4 I will close with that and open
5 it up for any questions that you might have.

6 MR. STRASFELD: Mine's more in
7 the nature of an observation. Since I was
8 involved in this process since the
9 beginning, it seemed to me that Congress
10 must have had some awareness that they
11 wanted us to take the really broad reading
12 of this language that the model would have
13 to take into account every investment
14 conceivable in the world. It must have
15 known there is no model that could possibly
16 do that, I mean, in terms of it just
17 wouldn't be possible and the oral comments
18 have demonstrated that no matter whether
19 they were saying that yes, we can or no, we
20 can't. But the reality was they said there
21 is no model that can model the universe. So
22 that's what they intended. They must have
23 already known the answer to that. So why
24 would they have had us go through this
25 exercise?

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1 MR. LACKRITZ: First of all, I
2 think it's a really good question and I
3 think I don't know from a legislative
4 history that I've looked at there's a clear
5 answer. I suspect what they're trying to do
6 is I don't think anybody can anticipate what
7 technology can do in the future. So I think
8 what they were looking to you to do is to
9 see "Look. Is this feasible now? Is it
10 feasible 10 or 15 years from now?" Maybe it
11 will be at some point, but it's not feasible
12 now. So I think they've provided you some
13 flexibility, giving you direction, as to
14 here and now and in the future there may be.
15 You have some flexibility. That's the best
16 I can come up with. There's probably
17 legislative history we haven't found.

18 MR. STRASFELD: I'm still looking
19 if you find it email it to me.

20 MR. LACKRITZ: We'll absolutely
21 get it to you.

22 MR. STRASFELD: Thank you. Any
23 other questions? Yes.

24 MR. PIACENTINI: So I think I
25 understand the distinction you were talking

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1 about between advice delivered by a person,
2 by a professional, versus a computer and
3 some of the differences between the two.
4 But I guess my question is is there
5 somewhere a tradeoff to be made between the
6 cost and perhaps therefore the availability
7 of advice to a broader population versus the
8 comprehensiveness and maybe in some sense
9 the quality of the advice. Is there a
10 tradeoff to be made there?

11 MR. LACKRITZ: Sure. There's
12 always a tradeoff. I think there's, of
13 course, going to be tradeoff here. I think
14 what we've seen from surveys, what we've
15 seen from beneficiaries and investors that
16 we've surveyed, and we do this on an annual
17 basis and actually fairly periodically, just
18 like the ICI does with respect to their
19 surveys, these individuals wants clear,
20 understandable, relevant and timing
21 personalized information and yet there are
22 lots of ways you can imagine getting
23 information to investors. That's just the
24 first issue.

25 The second question is what are

1 we going to do about it and that's really
2 where investors need help. That's really
3 where we want investors to get the help that
4 they need which is your money --
5 relationship shows you're going to fall
6 short of what you need to retire at 60.
7 Okay. You're 45 years old right now. Your
8 assets are allocated a certain way in your
9 IRA and you're going to get a lump sum of
10 cash. I mean, the biggest challenge here is
11 that a lot of the IRA asset accumulation are
12 going to be lump sums of cash from defined
13 contribution plans that people are going to
14 take out at the same time.

15 So they're going to say to
16 somebody, "I have \$500,000 for my retirement
17 account. What the hell should I do?"
18 That's really where an advisor is really
19 important. That's when the computer model
20 will then spit back the question and say,
21 "What kind of equities are you interested
22 in" and you say, "Well, I'm interested in a
23 relatively low risk because my age is 45 and
24 I have 15 years until I want to retire" and
25 they're going to say, "Well, then you should

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1 be in high cap, large cap stocks, growth
2 stocks. You should be in large cap value
3 stocks. You should have a beta of no more
4 than X or Y." That doesn't -- I can tell
5 you that our daughters are far more computer
6 literate than I will ever be and they have
7 called me three times saying, "Look. I need
8 somebody to help me on this" and I think
9 that's something to take into account.

10 You are absolutely right. There
11 is a tradeoff here. But I think I would err
12 on the side of making sure that investors
13 got it right, not got it fast and cheap at
14 the lowest common denominator. You want to
15 make sure people get good, solid advice for
16 their own future.

17 MR. PIACENTINI: Okay. One other
18 question. You touched on a couple of
19 examples of specific types of investments
20 that maybe a computer model couldn't do a
21 good job of taking account of and I found
22 myself wondering how often will it be
23 appropriate for an IRA investor to get
24 advice down at that granular level, for
25 example, choosing stocks not only based on

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1 whether they are large or small cap or
2 growth or value but based on sector who are
3 deciding what they should do about an
4 individual security, perhaps whether to
5 shorten an individual company as in your
6 example. Is that something you think should
7 be part of the advice picture under
8 consideration for the majority of IRA
9 beneficiaries?

10 MR. LACKRITZ: Sure. I think,
11 first of all, this is not a one hit wonder
12 to use the vernacular from pop culture. I
13 mean, this is a continuing process.
14 Investing is not for amateurs. It really
15 requires constant- and nurturing. I mean,
16 what happens when the market drops five
17 percent all of a sudden because of something
18 in Asia? Lots of people with lots of money
19 tied up in the markets all of a sudden can
20 get really panicked and a computer doesn't
21 exactly say "Don't panic. It's going to be
22 fine" or "Double down" or "Double up" or
23 "Sell" or "Buy."

24 It's an ongoing process and I
25 think part of what I would urge you to

1 remember in taking account of this kind of
2 deliberation is that this is an ongoing
3 process. You get a snapshot at one
4 particular point in time and it's like a
5 medical checkup. Every couple of years, you
6 want to make sure you keep it current. You
7 go back to the doctor every year for a
8 physical. You should be doing the same
9 thing with your retirement account.

10 MR. STRASFELD: Thank you very
11 much.

12 MR. LACKRITZ: Thank you.

13 MR. KANT: Good morning. My name
14 is Douglas Kant. I'm a Senior Vice
15 President and Deputy General Counsel in the
16 Legal Department of Fidelity Investments, a
17 financial services firm based in Boston.
18 I'm an ERISA lawyer and I work with our
19 retirement business. I'm accompanied today
20 by Robert McDonald who is a member of our
21 investment staff who is a Senior Vice
22 President with Strategic Advisors of
23 Fidelity Company.

24 As a first remark, I was kind of
25 hoping Bob would give me the height

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1 advantage but he tells me that Breyfogle has
2 about an inch and a half. So we're just
3 going to start by conceding the height.

4 I'm going to talk about a few
5 legal issues, a couple of which have been
6 beaten up pretty good already and then Bob
7 will really want to talk about the
8 investment challenges faced by he and his
9 staff in trying to construct or develop
10 computer models, computer-based methodology
11 to deal with the computer model rules under
12 the Act.

13 Fidelity Affiliates services
14 millions of IRA accounts. I will comment
15 that we are interested in the computer model
16 really both in the retail IRA space and in
17 the 401(k) world. So we care about both a
18 lot. Strategically, it's The Fidelity
19 Company that's been charged with developing
20 computer-based methodology. This will be
21 the engine that will drive the investment
22 services we want to provide to our
23 retirement clients that may be provided by
24 in maybe interactive websites, get a
25 website, maybe an phone interaction with our

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1 phone reps, maybe a face-to-face meeting
2 with a brokerage rep.

3 I also have to say that we're
4 working on this computer-based methodology
5 realizing that at the current time the only
6 rule we can rely on the level comp rule. So
7 right now, that's been our purpose. This is
8 a computer model. We'd like it to conform
9 to a computer model rule, but right now, we
10 don't know what that rule reads like. We
11 need a lot more filled in.

12 A couple of the earlier speakers
13 got into discussion with you about the basic
14 problems since the language in both the
15 computer model rule that requires the
16 computer model to take into account all
17 available investment options and then
18 somewhat different language in the PPA
19 provision that requires to go through this
20 feasibility/termination process that talks
21 about a computer model takes into account
22 the full range of investments including
23 equities and bonds and although in some ways
24 that has a more general feel to it,
25 nevertheless, it leaves us perplexed. It

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1 sounds like a very formidable obstacle to
2 try to produce a computer model that will do
3 all this.

4 I have to say from my perspective
5 the biggest concern we have right now is we
6 don't know what the rule means. And it's a
7 year after the Act. We really need the
8 Department to try to make some decisions. I
9 understand there's no legislative history,
10 but right now, we simply can't finish up the
11 computer model in terms of any comfort that
12 it will satisfy the rule because we don't
13 really know the methodology parameters, we
14 don't know the certification process and
15 certainly can't start the process of hiring
16 a computer model certifier. We just can't do
17 it yet. So for us, time is really running
18 by. Again, this is true in the IRA space
19 and 401(k) space equally.

20 A couple of other issues I will
21 mention on the legal front. The computer
22 model rule says the model should respond to
23 preferences, investor preferences, as the
24 certain types of investments. We would
25 assume that means that we can solicit the

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1 preferences in terms of, for example, what
2 types of investments they would like an
3 advice model based on. The statute seems to
4 support that, but we would really appreciate
5 confirmation on that point.

6 The other thing and this we
7 really struggle with this is the statute
8 requires, and this is part of the general
9 rule, part of the general conditions for
10 both rules, the statute says that we have to
11 give, our advisors have to give, investors
12 past performance and historical rates of
13 return of investment options available under
14 the plan. We can talk about this in the
15 401(k) world. If they really mean that
16 we're supposed to put investment information
17 in the hands of investors for everything
18 they can buy in their brokerage account,
19 it's impossible. It's not doable.

20 From our end, we assume that
21 providing access, making sure we make this
22 information available to the investor, is
23 the way to go and that may mean telling them
24 how, where to get the information if they
25 want it. Without that, I think we have

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1 problems under both rules. Without that
2 kind of practical approach to the statute, I
3 think we have problems under both rules.

4 And finally, we've heard several
5 pleas for you start work on a class
6 exemption. I think we would echo that from
7 our side and we've made comments on
8 interpretation of the statute in an earlier
9 submission we made in response to your RFI.
10 Another basic concern now is we may get to
11 the class exemption one way or the other. I
12 think we're going to need a class exemption.
13 I think we're going to need another rule, an
14 administrative rule, that can be crafted in
15 a flexible fashion. Class exemptions take a
16 long time. You know that better than I do.
17 So I think really this is sort of I'll end
18 with a plea to begin that work.

19 Now if you think that the statute
20 sort of warrants you to wait until the end
21 of the termination process, I guess then I
22 would ask you to be open to industry request
23 to start an class exemption projects anyway
24 because you don't need that authority. The
25 PPA authority is narrow. You can go much

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1 broader and we would certainly encourage you
2 to do that. If it requires an industry
3 submission to trigger that, so be it. I'm
4 pretty sure some people in this room would
5 be happy to accomplish that fairly quickly.

6 With that, I'm actually going to
7 turn it to Bob and let him give the
8 investment side and then either one of us
9 are available for questions. If that's all
10 right, I'm going to just have him start
11 right away. Thank you.

12 MR. McDONALD: We're employing
13 the unique tag team approach to the
14 presentation today. My name is Bob
15 McDonald. I'm the Senior Vice President
16 with Strategic Advisors, an indirect
17 subsidiary of FMR Corp.

18 As Doug mentioned, my brief
19 comments today will focus primarily on the
20 practical considerations associated with
21 constructing a computer model advice
22 solution that would conform to the
23 requirements of the PPA. Fidelity does not
24 currently offer an computer model investment
25 advice program to IRA participants,

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1 investors; however, we do use a computer-
2 based investment framework to facilitate the
3 delivery of investment education which may
4 provide some insight to think about how a
5 computer model investment advice program
6 might be offered within the IRA context.

7 The computer model based
8 framework that's currently in place in our
9 educational tool also limits the investments
10 in the portfolio that is modeled for the
11 participants to the broad universe
12 consisting of mutual funds, both Fidelity
13 and non Fidelity. Within those limits, an
14 IRA beneficiary can choose whether to view
15 model portfolios constructed either from an
16 Fidelity only universe or from the open
17 architecture unfettered universe of all
18 funds.

19 In addition, the tool allows
20 investors to express certain preferences in
21 defining the universe of these mutual funds
22 for purposes of constructing a model
23 portfolio. In the current tool, investors
24 can choose to focus on funds with either
25 below average expense ratios, funds with

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1 above average stock consistency, funds with
2 above average performance relative to an
3 appropriate benchmark or any combination of
4 those attributes.

5 The limitation of the investment
6 universe to mutual funds is really a
7 function of Fidelity's belief that asset
8 allocation across a set of diversified
9 investment options is most suitable for the
10 majority of its customers. The literal
11 requirement to take any consideration in the
12 full range of investments including equities
13 and bonds in determining the options for the
14 investment portfolio of the beneficiary does
15 present a significant challenge to the
16 development of the computer model advice
17 solution.

18 In order to build a computer
19 model that could credibly consider or
20 recommend the purchase and sale of the full
21 range of investments particularly individual
22 securities and nonstandard asset classes as
23 opposed to diversified investment options
24 such as mutual funds, a security would need
25 to be identifiable, its value would need to

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1 be reasonably quantifiable in some
2 objective, systematic fashion and some
3 measure of its historical behavior must be
4 observable or available.

5 Most IRAs are essentially open
6 architecture, brokerage accounts and, as
7 such, get invested in a wide, in fact,
8 nearly limitless range of investment
9 vehicles. Both the sheer number of these
10 potential holdings and the uniqueness and
11 complexity of many of the securities that
12 are eligible for purchase through such an
13 account may present insuperable challenges
14 to the development of the computer model
15 that would satisfy all of the literal
16 requirements of the PPA with respect to the
17 computer model IRA advice.

18 Even limiting the universe to
19 those assets for which pricing and return
20 data and certain fundamental characteristics
21 are readily available, it's not without
22 significant remaining challenges as you move
23 beyond the universe of diversified options
24 into a universe that includes, but is not
25 limited to, individual securities, both

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1 equities and bonds, options, futures,
2 commodities, currencies. A computer advice
3 model, as I said, must be able to evaluate
4 the expected return and risk including an
5 estimate of the unique idiosyncratic risk of
6 each security. It's also necessary to
7 specify the relationship of each security
8 with all other securities under
9 consideration.

10 This is a manageable challenge
11 whether working with a bounded universe of
12 diversified investment options. As a
13 practical matter, it represents a
14 significant challenge to characterize the
15 necessary attributes and relationships of
16 all possible securities.

17 As I said, both the sheer number
18 of these instruments and a uniqueness in
19 complexity make this whole effort rather
20 problematic. The expense of gathering,
21 consolidating, monitoring, validating and
22 continually updating the necessary data
23 would place an onerous burden on the
24 computer model provider.

25 The problem becomes intractable

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1 when nonstandard assets are required to be
2 modeled. A computer model has no systematic
3 ability to recognize or value assets such as
4 private placements, limited partnership
5 holdings, certain option strategies,
6 negotiated instruments such as swaps or
7 private company stock. As a general
8 matter, the computer model can only consider
9 any security that it can recognize value and
10 analyze.

11 This doesn't necessarily mean
12 that a computer model would or should
13 recommend the purchase of all securities.
14 For example, Fidelity's current educational
15 tool recognized individual securities in an
16 investor's existing portfolio for purposes
17 of assessing asset allocation, style
18 balance, security concentration. The tool
19 provides the investor with the flexibility
20 in analyzing their portfolio to either hold
21 these positions or to purchase and sell
22 individual securities in order to see the
23 impact of those actions on their overall
24 portfolio.

25 The model portfolio, however,

1 that's delivered to an investor consists
2 exclusively of mutual funds. In short,
3 Fidelity attempts to characterize the risk
4 of all positions owned by a customer but
5 limits the buy universe to mutual funds
6 selected according to objective criteria.

7 The same framework could be
8 applied albeit with a broader universe to a
9 computer model advice solution. Customer
10 holdings that could be identified and
11 characterized either individually or through
12 the use of asset proxies such as indexes
13 would be considered for purposes of
14 providing a holistic assessment of the
15 customer's overall portfolio.

16 The buy universe, the set of
17 securities and assets that would be
18 considered for purchase, could be limited
19 with appropriate disclosure to the subset of
20 all allowable IRA holdings that are both
21 allowed by the IRA trustee and have
22 sufficient data to recognize value and
23 analyze the assets. If the universe can't
24 be limited in this way, if all instruments
25 that could be owned in an IRA, must be

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1 considered, must be individually and
2 uniquely characterized and must be eligible
3 to be recommended for purchase, then the
4 literal requirement to take into account all
5 investment options would practically
6 speaking make the computer-based advice
7 model infeasible.

8 I'll stop there and we'll jointly
9 take questions.

10 MR. STRASFELD: Let me ask the
11 bottom line question which is reading the
12 language taking into account the full range
13 of investments, what in Fidelity's view does
14 that mean? Does it mean as you said every
15 conceivable investment in the world or some
16 subset?

17 MR. KANT: Can I give the
18 lawyer's answer?

19 MR. STRASFELD: Those are usually
20 less valuable, but sure.

21 (Laughter.)

22 MR. KANT: We'll give you two
23 answers so we can determine.

24 MR. STRASFELD: All right.

25 MR. KANT: I won't be surprised

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1 if you get the same response. I guess from
2 my side I think what Bob is trying to
3 describe is the challenge in really trying
4 to kind of grab the information for every
5 conceivable asset. From my side, and I've
6 tried to read the statute more liberally, it
7 says what it says and that's been a real
8 challenge for us because frankly if all I
9 have is the statute and I don't have any
10 sort of regulatory comfort, it seems to me
11 we just can't do it. It's just too much, I
12 think.

13 MR. McDONALD: And it think the
14 point that I was trying to make in my
15 remarks really was to focus on the middle
16 part of that phrase which is "take into
17 consideration" as well as the end part of
18 the phrase which is the "full range of
19 investments." If there is the opportunity
20 to characterize taking into consideration
21 the recognition of pre-existing holdings for
22 purposes of this holistic assessment, then I
23 think there are ways that you can
24 characterize broadly the full range of asset
25 class exposure associated with a customer's

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1 current IRA positions. It doesn't
2 necessarily extend then to that full range
3 of investment options necessarily being
4 appropriate for consideration within the buy
5 universe.

6 So I guess I was trying as I'm
7 thinking about how I would build such a
8 model if we could extend the current
9 educational framework to say "Let's do our
10 best to try and understand and characterize
11 what's currently being held regardless of
12 whether it's a mutual fund, a collective
13 trust, a separately managed account or any
14 of these other asset classes" but to focus
15 the buy universe in a way where we know
16 objectively we can characterize all these
17 assets and recommend a complimentary sort of
18 holistic investment solutions.

19 MR. STRASFELD: All right. Let
20 me try a follow-up. Let's assume that your
21 model can take into account the individual
22 holdings of an IRA beneficiary, but you only
23 make buy recommendations with respect to
24 either your family of funds or all the funds
25 that Fidelity offers. Would that in your

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1 view satisfy this requirement?

2 MR. KANT: I don't know what
3 you're -- What do you think?

4 MR. STRASFELD: Well, the purpose
5 of this hearing actually is to see what you
6 think.

7 MR. KANT: I really don't know.
8 I mean, you're taking them into account.
9 You're can only do it on one side of the
10 equation and I guess that's the big dilemma
11 for us in terms of is that enough.

12 MR. LEBOWITZ: Am I correct that
13 your reluctance to answer that directly sort
14 of suggests that we have a fair amount of
15 discretion in determining how to define
16 these terms?

17 MR. KANT: I think your views
18 seem to be a lot more important than mine.
19 So the answer is yes.

20 MR. PIACENTINI: Let me ask a
21 slightly different question. If the answer
22 was it is enough to limit the consideration
23 to recommending buy and so on, some narrower
24 field, is that enough in achieving the
25 result desired or would the advice sometimes

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1 be inadequate such that advice that was more
2 expansive, had more expansive consideration,
3 would have been better advice?

4 MR. McDONALD: Would the ability
5 to move beyond a bounded set of asset
6 classes lead to a deficient advice solution
7 in essence? Yes.

8 MR. PIACENTINI: Would the
9 inability to move past that be deficient
10 advice? That's my question. And if so,
11 why?

12 MR. KANT: If you're asking, for
13 example, whether a methodology that only
14 produces, say, a mutual fund solution was a
15 brokerage counselor, you have a much broader
16 universe of individual securities to pick
17 from. Putting aside what the statute
18 requires, I hope that's not an inadequate
19 answer because that same person may have a
20 401(k) account and I'd like to think that
21 the investment advice that they get which is
22 maybe just mutual funds is not adequate.
23 That's sort of a more general sort of
24 investment view of this. On the other hand,
25 the investment guy may have a different

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1 view.

2 MR. McDONALD: I think sort of
3 the organizing framework that we've used to
4 put our educational tools out there and I
5 think that we would use in an advice model
6 is that we're going to better serve the
7 customer, the vast majority of customers, by
8 putting together a broadly diversified
9 portfolio that delivers an appropriate asset
10 allocation that takes into consideration
11 preferences and personal attributes. I
12 think we can derive that diversification
13 benefit most efficiently for the vast
14 majority of customers through the use of
15 diversified building blocks or at least a
16 subset of all assets that may include
17 individual equities in some limited way.

18 I think the marginal benefit
19 associated with extending the opportunity
20 set beyond that into undiversified vehicles
21 has limited benefit for the vast majority of
22 IRA beneficiaries.

23 MR. KANT: I would mention just
24 we're really talking about what we're doing
25 now coming out of the gate.

1 MR. McDONALD: Yes.

2 MR. KANT: I certainly think that
3 our business people at Fidelity are
4 contemplating this, eventually the
5 investment advice, sort of would encompass
6 the range of individual securities to buying
7 a brokerage account. Just we're trying to
8 walk first.

9 MR. McDONALD: Yes.

10 MR. KANT: But I do think it is
11 incumbent on us to be able to at least
12 characterize what somebody walks in the door
13 with to the extent that we can so that we
14 can understand how we can improve their
15 situation or at least compare and contrast
16 where they are with where they might be with
17 a diversified investment advice solution.

18 MR. STRASFELD: Thank you very
19 much. Why don't we take a ten minute break
20 and come back at 11:10 a.m. Off the record.

21 (Whereupon, the foregoing matter
22 went off the record at 10:58 a.m. and went
23 back on the record at 11:10 a.m.)

24 MR. STRASFELD: On the record.

25 MR. SMITH: My name is Michael K.

1 Smith. I'm with Zacks Independent Research.
2 I'm 6'4" and 220 pounds if you're keeping
3 score.

4 Zacks IFE is a business unit of
5 Zacks which has been around since 1978.
6 It's a source of independent research and
7 market data. Zacks IFE was founded in an
8 anticipation of the complication of audits
9 in qualified plans. We are a 330 investment
10 manager of fiduciary allocator for the QDIA
11 defaults, customized life cycle funds,
12 demographically adjusted balanced accounts
13 and managed accounts as described in the
14 Advisory Opinion 2001-0-9A. The Fund also
15 provides audit services for computer-
16 generated proprietary advice models for
17 parties in interest seeking to comply with
18 Section 601 of the Pension Protection Act.

19 A way of background, I was a
20 consultant along with the late Brian Tarbox
21 to SunAmerica on their success bid to take
22 discretion over participant assets invested
23 in their variable fee funds. Previously, I
24 was TCW when they received the prohibitive
25 transaction exemption that really created

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1 the computer modeling industry in qualified
2 plans. I'm an investor in three independent
3 modeling companies, party to a patent on
4 their implementation of qualified plans and
5 evaluated most of them for some of the
6 largest financial firms in the country.

7 As much as it pains me to say
8 this, I can confirm that conclusion of the
9 firms that are seeking class exemptions that
10 current computer models are ineffective in
11 considering all available securities in
12 their formation of advice.

13 One of the financial services
14 firms described 13 computer modeling tools
15 available to their facilitators in their RFI
16 response. At the end of the day, these all
17 do the same thing, forecast asset class
18 returns to create portfolios on the
19 efficient frontier. Some tools create 99
20 buckets of asset class allocations. Some
21 27. Some create nine. Mutual funds, ETFs
22 and similar pooled investments are the nat
23 to these buckets and managed on an ongoing
24 basis to arrive at a terminal wealth result.

25 This morning the panel would like

1 to know, I'm going to add some emphasis and
2 clarity from the question from the *Federal*
3 *Register* from last Wednesday, "What
4 particular types of investments or asset
5 classes should a computer model," a computer
6 model should not could, "take into account
7 in order to provide appropriate," not
8 perfect, "advice to IRA beneficiaries?"
9 Again, those emphases were mine.

10 The direct answer to the question
11 is pooled investments, preferably low fee
12 pooled investments such as funds, ETS or
13 collective trusts that capture the asset
14 class category returns in areas such as
15 domestic and international equities, mid,
16 large, small growth and value categories,
17 international, high yield and high grade
18 bonds. These are the asset classes and
19 vehicles that computer models should
20 consider to form prudent portfolios.

21 Again, I can see that a tool
22 someday may be developed that can create a
23 seemingly infinite number of portfolios on
24 the efficient frontier using a seemingly
25 infinite number of securities. But so what?

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1 Effective and appropriate portfolios can be
2 attained using the inputs I've described for
3 results that are very similar, defined as
4 terminal wealth and standard deviation from
5 of terminal wealth.

6 The next question on the agenda
7 in the *Federal Register* in the agenda last
8 Wednesday was related to safety and
9 prudence. The panel has asked the industry
10 to clarify how inherent biases can be
11 ameliorated from these model specifically
12 "the Department seeks additional information
13 on the manner in which such programs could
14 operate without bias as to the investments
15 offered by the fiduciary advisor or
16 affiliate if the particular advice program
17 allocates IRA assets only among such
18 investments." Here we would recommend that
19 the construction and assignment of
20 allocations be controlled by an independent
21 fiduciary and minimum proprietary models
22 should be audited by an independent expert
23 to assure investors that the advice is with
24 a range of advice that a similar expert
25 would formulate for their given set of facts

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1 and circumstances, the fees are reasonable
2 and that the self viewing has been removed.
3 To further ensure an unbiased result, we
4 would hope that the independent fiduciary
5 allocators compensation from the party
6 interest is not an unreasonable percentage
7 of their revenue.

8 As someone who has been involved
9 in the development of computer model
10 products and qualified plans from the
11 beginning, I can tell you that the goal is
12 to control participant emotions. As fee
13 hearings on Congress are announced and class
14 action lawsuits are filed and as 150 million
15 working Americans listen to media stories on
16 fund scandals, the best way to restore trust
17 in the system is to remove the ability for a
18 party and interest to self-deal. That was
19 the goal of our work at TCW and SunAmerica.
20 About \$40 billion has been invested in this
21 matter and we hope the Department will
22 consider adding such protections in the
23 formations of IRA advice.

24 Those are my comments.

25 MR. STRASFELD: In your view,

1 what is the answer to the question we raised
2 over and over again as to the meaning of
3 "takes into account the full range of
4 investments"? Is it as you suggested that a
5 pooled diverse universe is sufficient?

6 MR. SMITH: The answer to your
7 question is yes. I don't interpret the work
8 on Congress as in qualifying plans clearing
9 up, moving uninvolved participants to manage
10 portfolios, professionally manage
11 portfolios, life cycle funds, manage
12 accounts, balance funds. I don't see how
13 they went from cleaning up that, do it
14 yourself, choose from the investment roster
15 in appropriate investments to default into
16 professionally managed investments on the
17 efficient frontier. I don't see how they
18 then extended that in reverse to in the IRA
19 arena go out with any investment, security,
20 limited partnership, options, futures,
21 Mexican time share, Salvador Dali
22 lithographs, anything out there, It seems
23 to be consistent with the statute on the
24 qualified accumulation side of pooled
25 investments as I've described as the intent

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1 of the statute.

2 MR. STRASFELD: Any other
3 questions?

4 MR. LEBOWITZ: You started your
5 testimony by saying that you thought the
6 answer to the question was no.

7 MR. SMITH: Correct.

8 MR. LEBOWITZ: So what was the
9 question you were raising at that point.

10 MR. SMITH: Peer model tools that
11 consider every security available to an
12 investor. The answer is no.

13 MR. LEBOWITZ: Right. That's
14 consistent with all the comments.

15 MR. SMITH: Yes.

16 MR. LEBOWITZ: But in some sort
17 of surrogate fashion, there are such things.

18 MR. SMITH: Yes.

19 MR. LEBOWITZ: In terms of these
20 pooled investment options that cover various
21 asset classes.

22 MR. SMITH: If the universe were
23 constrained to pooled asset class, sector-
24 based investments, yes, there are computer
25 model rules that can do a perfectly fine

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1 job. Again, at the end of the day, we're
2 trying to get to a terminal wealth goal.
3 Whether you use that using low fee index
4 type funds, mutual funds or 6,000 individual
5 securities. They're all getting to the same
6 place.

7 So the spirit again, the spirit
8 of the legislation I felt was, we feel is,
9 for safer and more prudent and more
10 effective retirement outcomes, more
11 effective to define as people will use it.
12 The fees aren't too high. The inputs and
13 the outputs aren't too complicated and the
14 model I've described I think using a
15 constrained universe is consistent with the
16 accumulation portion of the statute.

17 MR. STRASFELD: Joe.

18 MR. PIACENTINI: When you talked
19 about independence related to evaluate the
20 impression of whether there's bias, you said
21 something about to see whether the advice
22 was within the range that somebody else
23 would be giving and I guess an ongoing
24 question in my mind is how much divergence
25 and advice might be attributable to bias

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1 versus how much might just be expected in
2 some kind of noise that different models
3 will have somewhat different investment
4 theories or different ways of characterizing
5 other assets that the individual might hold.
6 So how does one distinguish bias from that
7 kind of noise?

8 MR. SMITH: Two issues. One is
9 the actual output as I described along the
10 efficient frontier and I think everybody
11 does that pretty much the same. We all look
12 at the same data as far as asset cost
13 returns, inflation aggregates, things like
14 that.

15 What I'm suggesting or what I'm
16 discussing is more the construction of that
17 advice, what vehicles are used, how can it
18 be ensured that a party and interest
19 doesn't self-deal, tilt allocations toward
20 variable fee funds which is in our economic
21 interest to do so or in a flat level
22 environment we talk about flat level fees.
23 Flat levels doesn't equate to flat profits
24 necessarily. It could go the other way and
25 that's where I think it's beneficial to have

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1 an independent third party come in and
2 evaluate those systems.

3 The other recommendation I made
4 very clearly is that entity shouldn't be
5 taken too much money from their client.
6 I've seen some suggestions of a college
7 professor signing off on these things. I
8 think \$100,000 to \$200,000 to a college
9 professor is a meaningful amount of money.
10 So we, our business, as we look at the 601
11 audit won't take any more than five percent
12 of our overall revenue from any one of the
13 parties and interests whom we evaluate.

14 MR. STRASFELD: Thank you.

15 Morgan Stanley. Matthew Thomas.

16 MR. THOMAS: Good morning. My
17 name is Matthew Thomas. I'm the Executive
18 Director with the Morgan Stanley Global
19 Wealth Management Group and the Director of
20 their Financial Planning area. Also with me
21 today is Bill Ryan from our ERISA Counsel
22 Office and Wes Collum from our Government
23 Relations Office.

24 I appreciate the opportunity to
25 speak today. Morgan Stanley believes that

1 the retirement security of millions of
2 American workers depends on their ready
3 access to investment advice with respect to
4 their private retirement savings. As more
5 assets are contributed to and transferred to
6 IRAs, many roadblocks to infect the
7 investment advice will have a long term
8 adverse impact on these IRA beneficiaries
9 and ultimately on the retirement security.
10 My remarks today will focus on the
11 feasibility of computer-based investment
12 advice for IRA accounts covering the
13 universe of investments that these accounts
14 may invest in.

15 Morgan Stanley is a global
16 financial services firm. Various affiliates
17 of Morgan Stanley provide brokerage,
18 custodial investment related services to
19 IRAs including acting as a nonbank IRA
20 custodian for more than 1.45 million
21 accounts. These IRAs are invested in a wide
22 range of products, corporate stocks, bonds,
23 more than 2,200 open ended mutual funds and
24 over 100 fund families. These are advised
25 by Morgan Stanley affiliates, Van Kampen and

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1 Morgan Stanley Investment Management as well
2 as other nonaffiliated advisors. Also
3 included are ETS, corporate, governmental
4 bonds, debt instruments, structured notes,
5 alternative investments as well as hedge
6 funds, private equity funds, fixed and
7 variable nonqualified annuities and foreign
8 investments.

9 These IRAs total approximately
10 \$123 billion. In addition, custodial IRAs
11 offered through Morgan Stanley Investment
12 Management and Van Kampen with State Street
13 Bank and Trust Company as IRA custodian
14 comprise an additional 400,065 IRA accounts
15 with an aggregate value of approximately
16 \$4.3 billion.

17 Morgan Stanley in the aggregate
18 has assets under management of more \$690
19 billion for these and other clients. Given
20 this scope we believe that are well
21 positioned to provide the Department the
22 benefit of our experience and understanding
23 in the investment advice area as it examines
24 computer model investment advice programs
25 for IRAs as described in Section 601 of the

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1 PPA.

2 Morgan Stanley believes that with
3 the maturing of the baby boomer generation,
4 the need for retirement planning will become
5 more complex as investors begin the
6 transition from investor accumulators to
7 spender D accumulators. Getting investors
8 from early retirement to the last stages of
9 life will require customized analysis
10 management not only to households' financial
11 assets but a detailed strategy to meet both
12 the planned and unplanned liabilities of
13 retirement in late life.

14 Investment advice is only one
15 component of a truly client-centric
16 retirement solution. The other components
17 are a sound financial plan, a disciplined
18 approach to creating retirement income and a
19 rigorous ongoing monitoring process for
20 client retirement accounts, all of which can
21 be supported and delivered by investors by
22 today's technology. We believe that this
23 advice process will prove to be the hallmark
24 of a successful retirement planning in the
25 near future.

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1 Focusing on investment advice
2 component for the moment, Morgan Stanley
3 believes none of the computer modeling tools
4 which we use or which are commercially
5 available can take into account the full
6 range of investments including individual
7 securities, equities, bonds and to
8 determining investment performance options
9 for IRA account holders. While such a
10 computer model may appear ready for
11 development in the future, right now, it
12 simply does not exist. Therefore, based on
13 the matter in which IRAs that we see at
14 Morgan Stanley are currently invested, the
15 mandated use of computer models to give
16 advice can only limited the client's ability
17 to fully evaluate and select all potential
18 investments options.

19 The intellectual underpinnings of
20 most allocation modeling tools do not lend
21 themselves to specific product level
22 recommendations outside of the mutual fund
23 context. Account availing issue, the
24 concern about the embedded fees and cost
25 structures in mutual funds and mutual fund

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1 related products that they are subject of
2 Congressional, SEC and DOL focus may work
3 against the Department primarily relying on
4 a tool which is best suited to mutual funds.

5 To the extent that computer
6 models in 2007 can best allocate across
7 asset classes using the type of vehicle with
8 any real degree of accuracy, mandating
9 computer models for IRAs limit IRA
10 beneficiaries from the investments they have
11 shown interest in and the asset type
12 specifically points to by Congress in the
13 PPA that should be considered.

14 Virtually, all computer-based
15 models are based on the intellectual premise
16 that a diversified and efficient asset
17 allocation of an investment portfolio offers
18 clients the ability to analyze and make
19 rational risk return investment decisions.
20 The basic goal of asset allocation is to
21 diversify away some of the inherent risk of
22 investing in just one or two asset classes.

23 Through asset allocation it is
24 possible to reduce the overall volatility of
25 an investment portfolio by introducing

1 different asset classes that have different
2 performance and volatility characteristics.
3 Asset allocation offers investors two
4 primary alternatives, the ability to achieve
5 the greatest investment return possible for
6 a given risk or required rate of return with
7 the least amount of risk possible. These
8 alternatives are produced by creating
9 estimates for how individual asset classes
10 are expected to perform over time in the
11 near future, that is their future investment
12 return; how volatile these asset classes
13 will behave over time into the future or
14 their standard deviation; and the
15 relationship between an individual asset
16 class's return in volatility as compared to
17 other asset classes over time referred to as
18 correlation.

19 And important application in
20 incorporating these three assets is mean
21 variance optimization. Mean variance
22 optimization takes into consideration all
23 the individual asset classes identified.
24 Variations between asset allocation
25 approaches are largely influenced by how a

1 particular asset class is defined, whether
2 it's small, medium or large cap, foreign or
3 domestic, and whether an particular asset
4 class such as an esoteric class as high
5 yield or alternatives are considered for
6 possible inclusion in an overall investment
7 portfolio. Thereafter, mean variance
8 optimization combines all the possible mixes
9 of asset classes into the portfolios with
10 their own expected returns and standard
11 deviations.

12 I highlight these concepts for
13 the following reason. The computer model
14 portfolios themselves are comprised of asset
15 classes, not specific investments. And the
16 economic theory is underpinning. The models
17 require in effect aggregate historical rates
18 of return and volatility for such classes.

19 When the range on investment
20 options offered to a particular client is
21 both constrained and constructed to mirror
22 the broad investment classes, but limited to
23 vehicles for which data inputs are readily
24 available and reasonably limited such as
25 mutual funds with each fund in turn

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1 representing a pool of individual
2 investments that generally fits within
3 certain broad asset categories, again, large
4 cap, small cap, domestic and foreign, the
5 portfolio models generated by various asset
6 allocations programs are useful tools that
7 plan participants can use to apply to the
8 efficient frontier analysis to the
9 retirement plans but artificially their
10 selection of actual investments.

11 If, however, you permit
12 investments like IRA beneficiary and
13 individual instruments, individual against
14 stocks, bonds, annuities, alternative
15 investments, such investments either do not
16 clearly correlate to a particular asset
17 class or may be inherently more volatile if
18 issued by a single legal entity than a
19 pooled vehicle. This is due to the
20 individual instrument's specific,
21 unsystematic or what we might refer to as
22 idiosyncratic risk.

23 Existing computer models are not
24 designed to choose particular investment
25 products or solutions that fall outside the

1 pooled vehicle context and even if they
2 produce particular recommendations, that is
3 a list of available products, it cannot
4 adequately ensure that these solutions are
5 optimal within the efficient frontier
6 framework.

7 Morgan Stanley's Global Wealth
8 Management Group and its 7,500 financial
9 advisors currently employ a variety of
10 proprietary and nonproprietary computer-
11 based asset allocation programs and tools
12 that are used to analyze client assets
13 including IRA assets and form the basis of
14 an asset allocation recommendation. This
15 asset allocation is just the first step in
16 investment advice and a high level step as
17 well. The actual selection of investment
18 products is not generated by a computer
19 model because in today's technology there is
20 no model able to translate asset class
21 decision into particular stocks, bonds,
22 structured products, etc.

23 In our written response to the
24 Department's request, we outline the asset
25 allocation investment products that Morgan

1 Stanley Financial Advisors currently use. I
2 was planning to discuss these features but
3 in the interest of time we're happy to
4 provide further descriptions of these
5 products in writing to the Department if you
6 think that's appropriate. The products I'm
7 speaking of are things like Asset Scan, our
8 portfolio architect advisory mutual fund
9 program, our Fund Solution mutual fund
10 advisory program, Custom Portfolio which
11 advises on a basket of stocks, not
12 individual stocks.

13 To briefly summarize, all these
14 products to a greater or lesser degree
15 attempt to model asset allocation strategies
16 using variants of mean variance optimization
17 and provide clients and their financial
18 advisors with various detailed projections
19 of potential investment outcomes determined
20 in part through the use of Monte Carlo
21 modeling techniques.

22 However, these asset allocation
23 tools as generally described above suffer
24 the following limitations. The models tend
25 to evaluate portfolios by asset classes and

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1 readily available indices in the attempt to
2 fit the instruments held in a client's
3 portfolio within these categories. Not all
4 asset allocation tools, however, uniformly
5 characterize the investments as falling
6 within a particular asset class.

7 Each model may have a particular
8 variations that while within generally
9 accepted investment guidelines treat
10 particular instruments differently.
11 Further, these models perhaps may tell you
12 what an asset class your investment is in
13 but they can't tell you what investment to
14 put your asset class in afterwards. So they
15 have very little front-end use in selecting
16 portfolios of assets.

17 To the extent particular models
18 offer fulfillment options of clients, the
19 recommendations made almost exclusively
20 focus on mutual funds options or a fixed
21 universe of investment options offered with
22 a particular advisory program. We know of
23 no programs that can either properly
24 evaluate or make specific recommendations
25 for the following instruments, especially in

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1 a brokerage context with a wide variety of
2 potential investments described below. That
3 universe would include individual stocks
4 such as described in the Wilshire 5000
5 Index, corporate bonds, foreign debt or
6 equity securities, currency instruments or
7 currencies themselves, futures, annuities
8 whether they be fixed or variable, options,
9 alternative investments as organized through
10 limited partnerships, group or collective
11 trusts.

12 Separate and apart from the fact
13 that these models are incapable of offering
14 specific fulfillment options other than the
15 limited world of mutual funds, we would also
16 note that the mathematical premises of the
17 modeling techniques used generally relate to
18 portfolios rather than specific investments.
19 Even if a model could generate particular
20 bond or individual stocks to comprise an
21 asset class or to wholly fulfill an asset
22 allocation recommendation, that result would
23 introduce an unacceptable level of
24 unsystematic or idiosyncratic risk that
25 would substantially understate the potential

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1 for volatility in the model and would, we
2 believe, mislead the client to believing
3 that a portfolio is optimized for risk
4 return purposes. These are, at least, in
5 the foreseeable future fundamental and in
6 our view insurmountable challenges to a
7 computer-based advice model for IRAs.

8 But there are also significant
9 practical challenges. The potential
10 transactional cost to the client of
11 continuous reinvestment or realignment of
12 their current IRA assets to follow the
13 advice of a new model are not insignificant.
14 To that point, the Department should take
15 notice that the recent abolition of fee-
16 based brokerage options, the revocation of
17 the so-called Merrill Rule, which compels
18 brokerage accounts to charge clients on a
19 transaction-by-transaction basis rather than
20 a fixed fee for all brokerage transactions
21 in a year. This may have unintended
22 consequences of actually increasing the cost
23 of such computer-generated reallocations.
24 Further, in the aggregate, any mandatory
25 reallocation of IRA assets based on changes

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1 to the computer models host the potential to
2 cause a significant level of dislocation
3 within the capital markets as the sheer size
4 of IRA assets begin to move.

5 The cost of creating a model with
6 a data span necessary to cover all potential
7 individual investments is, we believe,
8 extremely high and would require computer
9 functionality in excess of what we believe
10 most laptop solutions would currently
11 support which would be a cost that neither
12 Morgan Stanley nor other providers of which
13 we are aware is currently interested in
14 pursuing.

15 So, first, the model isn't
16 available and, second, if it were, we
17 wouldn't afford to provide it through our
18 7,500 advisors because of laptop
19 limitations. As a practical matter, if it
20 can't be delivered through the most
21 efficient delivery system at the individual
22 level that the financial industry has to
23 offer, I have to wonder can it be seriously
24 considered.

25 A model-driven advice model will

1 place undue constraints on future product
2 development in the retirement arena and
3 reduce the financial services' ability to
4 quickly meet emerging needs to pre and post
5 retirees. While Morgan Stanley is a leading
6 provider of indices used as the basis for
7 most of the current computer models used in
8 the market, even Morgan Stanley believes
9 that certain public data does not currently
10 exist which enable a model to provide the
11 kind of information which a beneficiary
12 would need to appropriately consider each
13 investment. That is we are not currently
14 aware of indices that are readily available
15 to consistently classify and analyze all
16 potential investments that may be offered to
17 an IRA holder.

18 As described above, we are
19 concerned that the fundamental parameters of
20 mean variance optimization and the efficient
21 frontier theory which are designed for
22 entire portfolios do not readily translate
23 themselves to non mutual fund, non pooled
24 investment vehicles that mimic entire asset
25 classes and that IRA clients relying on such

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1 models receive a false sense of security as
2 a tradeoff of risk and reward.

3 In our experience, the primary
4 flexibility an IRA client has had in
5 modifying the model's output is through the
6 questionnaire which allows the client to
7 exclude certain types of investments from
8 considerations, investments that may only
9 have a short history or the ability of the
10 client to choose not to include proprietary
11 or mutual fund managers affiliated with the
12 current financial institutions. But it has
13 been Morgan Stanley's experience that many
14 IRA clients simply disregard model outputs
15 if they do not, for example, include
16 particular types of investment classes or if
17 they are not capable of evaluating
18 particular bond fund or pooled investment on
19 their own.

20 Morgan Stanley does not believe
21 that any models available today given that
22 they are constructed on a portfolio theory
23 basis will satisfy the criteria if nonpooled
24 investment or assets that do not easily fall
25 in particular asset categories are included

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1 given that Congress clearly intended IRAs to
2 receive investment advice on individual
3 securities as well as other potential
4 investments.

5 We are not clear how the
6 Department can approve a computer model that
7 simply cannot prudently take these
8 investments into account. Such models may
9 mistake both the asset class performance and
10 volatility with such investments. Thus, we
11 believe that any such model will take into
12 account the universe of investment options
13 available to IRA holders or therefore allow
14 the IRA owner sufficient information to
15 evaluate these investments appropriately.

16 Assuming this is the case, the
17 next logical step is for the Department to
18 determine consistent with the requirements
19 of the PPA what kind of relief can be
20 offered in lieu of a strict reliance on
21 computer-based models for IRAs.

22 We think a more nuanced approach
23 is possible. We think an alternative based
24 in part on an audible computer-based asset
25 allocation system could be retained since

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1 the asset allocation methodology clearly has
2 value especially by contrast to a fee-
3 neutral approach that does not specify any
4 qualitative portfolio analysis, a condition
5 for exemptive relief.

6 However, since we believe that
7 Congressional intent was to exempt
8 investment transactions made in connection
9 with such models and that such models need
10 to be modified to take into account
11 individual securities, annuities or other
12 investments, some link between the model
13 asset class and the investment could be
14 demonstrated along with the requirement of
15 the advisor in recommending these purchases
16 would clearly need to disclose the
17 compensation and potential conflicts
18 inherent in tallying the advice to deal with
19 all the potential investment options. It is
20 in this area that we believe the Department
21 should focus its attention as a starting
22 point in the creation of specific relief and
23 continue to allow the collaboration between
24 traditional asset allocation approaches
25 augmented by individualized security

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1 selection.

2 Thank you.

3 MR. STRASFELD: Thank you. Allen
4 Vaughan, 401(k) Advisory Group.

5 MR. VAUGHAN: I'm going blind.
6 So I have to use this. I'm not the most
7 eloquent public speaker either. I'm more of
8 a teacher but just bare with me.

9 I'm Allen Vaughan, President and
10 Founder of the 401(k) Advisory Group located
11 in Atlanta, Georgia and as my bio reflects
12 that I gave to Chris, I've been in the
13 retirement plan industry since 1984 working
14 inside retirement plan operations and
15 administration and now on my own for the
16 last three years where I created the 401(k)
17 Advisory Group really as a response to a
18 huge gaping hole that I saw in the
19 retirement plan industry. We utilize what I
20 call prudent, due diligence and standards of
21 care outlined by the Senate for Fiduciary
22 Studies and I founded this company primarily
23 to provide advice to the participants as
24 well as to the plan sponsors in a
25 participant driven environment, more so,

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1 than just providing a spreadsheet of the
2 funds in the current menu and trying to sell
3 a plan. We're out there trying to make a
4 real difference with our clients.

5 So I'm in the trenches working
6 with those plan sponsors and their employees
7 directly and I think that gives me a unique
8 perspective today. I'm not an attorney and
9 although I've worked for many of the largest
10 banks, insurance companies and brokerages
11 here in the U.S. inside the retirement plan
12 operations departments, I'm not some multi-
13 national investment firm. As Dr. McCoy used
14 to say, "I'm just a country doctor." This
15 is what I've been doing in working in the
16 trenches with employees. So I hope my
17 feedback to you today and my input, it will
18 be unfiltered and directed and nothing
19 really subject to interpretation.

20 But what I see inside the 401(k)
21 world, I also see within the IRAs. For
22 example, my first 401(k) plan in 1990, the
23 plan sponsor had a 1980 Jaguar as a company
24 asset held within the fund or within the
25 plan and it was his daily driver. I know a

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1 more recent plan was a medical practice in
2 Florida where the doctors were going out and
3 buying low rent housing, throwing in a
4 toilet, putting in some carpet and flipping
5 the house, no audit procedures, nothing like
6 that at all and as you can imagine with the
7 market as it is down there now, those guys
8 are really having a hard time getting rid of
9 plan assets and liquidating them. As far as
10 I know, they're still doing that kind of
11 activity.

12 One of the points in common with
13 IRAs and 401(k) plans is the vacuum of an
14 established process of prudent selection of
15 investments at the individual account level
16 and even more poignant has been the outcomes
17 within both. As you heard in prior
18 testimony this morning on behalf of the ICI,
19 there's over \$4 trillion in assets in IRAs
20 and as you probably already know, there is
21 \$2.7 trillion assets in defined
22 contributions in 401(k) plans. That's \$7
23 trillion. I don't know how much is in the
24 markets these days, the securities, but the
25 total market capitalization in the United

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1 States is \$75 trillion. So these assets are
2 nearly 10 percent of the American economy,
3 ten percent.

4 But as an example of just how
5 poor the average investor has performed
6 inside these accounts, there are some good
7 statistics that show that. For example, the
8 S&P 500 over the last two years has average
9 about 12 percent annual returns, but the
10 average stock investor has only earned and
11 bond investor has only earned between three
12 and four percent and there's no telling what
13 these individuals who have had nonregulated
14 securities have done.

15 Since 2004, I have performed
16 several participant-focused consultations
17 for plan sponsors and in that research I
18 have found some interesting common traits
19 I'd like to share with you that I think are
20 very important in this decision regarding
21 computer-generated programs for IRAs.

22 On a consistent basis, plan-by-
23 plan, I saw roughly 20 percent of
24 participants picking either every fund of
25 the plan's menu or every fund less the money

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1 market or the stable value account. In
2 plans that offered lifestyle fund options,
3 some of the latest, greatest out there,
4 nearly one-third of the participants choose
5 the lifestyle funds, but in those plans I
6 could not find a single employee who had
7 correctly utilized their selection. What I
8 found were people selecting one, two or all
9 the lifestyle funds in conjunction with
10 using other funds on the menu.

11 The percentage of participants
12 that choose to place all of their moneys
13 into a money market or stable value account
14 varied between 25 to 30 percent of the
15 employee universe. Roughly, another 20
16 percent picked only equity fund options and
17 the percentage of people that displayed a
18 semblance of utilizing what looked like an
19 intelligent allocation model based on their
20 age and nearness to retirement was less than
21 two percent. Less than two percent. Now
22 you couple that with the fact that the
23 average participation rate in this country
24 is around 72 percent right now of eligibles
25 and we're only covering maybe 50 percent of

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1 all the working population with these plans,
2 you have a real problem.

3 I knew that if these people even
4 got advice from a broker more often than not
5 the advisor is nothing more than gut-hunches
6 and guesstimates and not based on sound
7 principles of investment management. Maybe
8 they were just looking pie chart and saying,
9 "Here. This is what you need to do because
10 you're 55 years old and you're close to
11 retirement. So let's just build this
12 portfolio around this." Inside of 401(k),
13 they're not even supposed to do that.

14 So I started working on the
15 retirement coach software back in late 2004
16 to keep my firm from falling into the same
17 trap with regard to providing consistent
18 advice no matter the employee's age, near to
19 retirement or risk sensitivities. This
20 computer modeling program is used in a
21 level fee environment. It is a mandatory
22 system that I've used of one-on-one
23 enrollment coupled with investment advise.
24 The participant has to strenuously avoid
25 seeing me.

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1 Now it's only used with mutual
2 funds. That's the only investment vehicle
3 I'll use. I don't work with nonregulated
4 securities. And although I've built it to
5 where you possibly could, the issue is my
6 choice as an investment fiduciary to the
7 plan, as a fiduciary advisor and investment
8 manager to the plan, I don't use those fund
9 options.

10 The first plan to go to that
11 process was in March of 2005. Now some of
12 the results I've had, I've had nothing less
13 than 95 percent participation of the
14 eligibles. I have plans that have 100
15 percent participation and their human
16 resources managers, whenever an employee
17 becomes eligible, they give me a call and I
18 run down there and I enroll their employees
19 and they put in the right percentage of the
20 deferral rate and we use the established
21 allocation models that are inside the
22 program. In short, participants in the plans
23 in which we provide fiduciary management and
24 advisory support have their moneys prudently
25 invested. They also know that they are

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1 putting the right amount of moneys into
2 their plans. They know exactly what the net
3 impact is on their paycheck.

4 But there are some weaknesses to
5 this program that I want you to know about
6 and this would be universal with any kind of
7 program. It can be subverted to aid the
8 using advisor of broker and providing more
9 compensation based on the allocation model's
10 design. That is you can tweak those slices
11 of the pie chart. Now whether he gets paid
12 X here and X times 2 here according to Bruce
13 Ashton, and I shouldn't really stand in his
14 stead here, but the opinion is that's not
15 necessarily against the law but it is
16 certainly unethical and I find that really
17 troubling with these allocations programs.
18 That's why I think there needs to be a
19 prudent process involved in working with
20 these plans.

21 Next, the user could utilize
22 virtually any asset allocation modeling
23 system he or she desires, be it Monte Carlo
24 or New Variance or simply eyeballing it.

25 Finally, the program does nothing

1 in the realm of creating a process of
2 prudent standard of care for the plan or its
3 participants.

4 I think these three issues are
5 what I see also provides a challenge for
6 IRAs and what I'd like to see are these
7 three points to become reality and it's
8 maybe somewhat pie in the sky but I think
9 that it deserves some discussion at some
10 future point.

11 First, that the Department of
12 Labor begins the process of creating a set
13 of guidelines for the prudent process so
14 that a reasonable standard of care can be
15 quantified irregardless of who builds the
16 program. Other people in private industry
17 have already done this. So I think 90
18 percent of the framework has already been
19 done.

20 Number two, on the form 5500, I
21 think there needs to be additional reporting
22 as to who the fiduciary manager and who the
23 fiduciary advisors are for the plan and I
24 think that information will be very helpful
25 to the DOL as far as enforcement and

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1 auditing processes are concerned.

2 And, finally, I think, this is
3 really the pie in the sky, my desire is that
4 DOL begins the process of limiting the menu
5 of future investment purchases inside
6 401(k)s and IRAs only to pool the
7 investments that are regulated by the SEC
8 for disclosure and auditing purposes as well
9 as the standardization of data for a uniform
10 methodology of research within the complete
11 set of investment alternatives. That is no
12 real estate, no other tangible or physical
13 assets. Frankly, those who represent these
14 types of investments and want them to remain
15 as investment alternatives simply want to
16 avoid due diligence reporting and oversight
17 of being held within a pooled, regulated
18 security.

19 How do you quantify risk with
20 art? How do you quantify risk with a shelf
21 full of Corvette parts? You can't. How do
22 you quantify the risk of holding a piece of
23 South Alabama non timber real estate? You
24 can't. And therefore you can't quantify
25 risk. So you simply cannot utilize an asset

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1 allocation modeling technique which is
2 predicated on quantifying risk for that
3 participant or IRA beneficiary. And if you
4 can't quantify risk and volatility then you
5 cannot provide prudent investment advice.

6 As a general rule in my classes,
7 I've provided advisory services only to plan
8 sponsors which do not have what I call
9 "nonpooled, nonregulated securities." If
10 they want it, then I just walk away from the
11 business.

12 Granted, mutual funds are not
13 perfect. For example, in this morning's *USA*
14 *Today's* Section B1, it says "U.S. Funds Add
15 Foreign Stockholdings." In fact, I have one
16 of those mutual funds in one of 401(k) plans
17 and when I get home, I'm going to start
18 proceedings to eliminate that fund because
19 that's the kind of stuff that messes up
20 asset allocation modeling. But with mutual
21 funds and regulated pooled accounts, you can
22 see that. That's reported. It's disclosed.
23 You can't see what generally a company holds
24 inside its holdings. So using a company
25 stock, I find, is rather difficult to work

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1 with in an asset allocation model or any
2 security that they may offer.

3 So that's all I have to add. Any
4 questions for me?

5 MR. STRASFELD: Exactly what is
6 the product that you offer to your clients
7 at your 401(k) plans? Is it some sort of
8 computer model?

9 MR. VAUGHAN: Absolutely.

10 MR. STRASFELD: And it's based on
11 generally accepted economic theories using
12 Monte Carlo simulations or something along
13 those lines?

14 MR. VAUGHAN: Absolutely.

15 MR. STRASFELD: And limited to
16 pools of some sort?

17 MR. VAUGHAN: Absolutely. That's
18 it.

19 MR. STRASFELD: All right. So in
20 your view, would the arrangement satisfy
21 this requirement under the statute with
22 respect to the determination we make that it
23 takes into account the full range of
24 investments?

25 MR. VAUGHAN: I think there needs

1 to be a reporting back to Congress about the
2 inability to provide that kind of computer-
3 based generated reporting for or asset
4 allocation modeling, for a participant
5 beyond a nonregulated security or even with
6 a stock or a bond.

7 MR. STRASFELD: Anything else?

8 MR. VAUGHAN: Now I'm not saying
9 that as a modeling and investment
10 management, our advice is an art. It's meat
11 and potatoes as far as math is concerned.
12 It's very scientific. But using real estate
13 or artwork or car parts, like I said
14 earlier, I think are inappropriate
15 investments inside qualified and
16 nonqualified IRAs.

17 MR. STRASFELD: So what would you
18 think should be in or what would be the
19 investment output of a model that you think
20 would be appropriate for 401(k) or IRA?

21 MR. VAUGHAN: In my program, I've
22 utilized Monte Carlo simulation. I switched
23 over from mean variance to Monte Carlo
24 simulation last year. I used 12 investment
25 classes that are firmly established by

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1 several financial planning folks in this
2 country. So in that respect, yes, I have
3 real estate but I use real estate mutual
4 funds. I have precious metals, but I use a
5 precious metals fund. There is
6 international bonds, but I use an
7 international bond fund. And so the
8 underlying risks characteristics of that
9 pooled investment are published everywhere
10 with Lieber and Morningstar or whoever so I
11 can make a determination of whether that's a
12 suitable investment for that menu. So prior
13 to any selection for that plan participant,
14 I've already selected that fund menu for its
15 appropriateness within that plan.

16 MR. STRASFELD: So your universe
17 is pooled funds.

18 MR. VAUGHAN: Exactly.

19 MR. STRASFELD: Okay. All right.
20 Thank you very much.

21 MR. VAUGHAN: Yes sir.

22 MR. STRASFELD: Lewis Harvey,
23 Dalbar.

24 MR. HARVEY: Good morning and I
25 appreciate the opportunity to speak here and

1 very briefly, Dalbar has been around since
2 1976. Our focus and mission has been
3 research in the financial services
4 community. Our particular relevance perhaps
5 in this discussion is the studies and the
6 work that we have done relative to investor
7 behavior and how that translates to
8 investment results for the individual
9 investor.

10 I'd like to do really three
11 things very briefly in the time I have here
12 and that is to recap the goal and the
13 problem that we're trying to solve here.
14 Secondly, I would like to give you three
15 reasons why the solutions as amended won't
16 work and also raise a couple of alternatives
17 for success.

18 Looking first at the goal, the
19 problem, clearly I think we'll agree that
20 the objective is to secure retirement income
21 for individuals and secondly, that there is
22 a problem with the current structure that's
23 in place. Given that that's the case, we
24 obviously need to change something. The
25 problem as we would define it would be

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1 poorly investment beneficiaries basically in
2 two areas. One is diversification and the
3 other is the access use of short-term assets
4 to produce long-term results.

5 The second part of the problem,
6 however, I think has been alluded to by
7 several speakers before and that is the
8 beneficiaries do act imprudently. They sell
9 and buy and trade at the wrong times. They
10 obviously need some help.

11 The general question is can the
12 proposed computer model correct the
13 situation without creating other problems.
14 I would like to suggest that the answer to
15 the key question that has been raised today
16 as to what did Congress expect could be
17 viewed from a different perspective if we
18 were to rephrase that question to ask
19 whether the Department of Labor can create
20 rules that would adequately select a
21 universe of investments to be used in the
22 IRA world. By changing that around, then it
23 seems to me that you have rational question
24 coming from Congress rather than what
25 clearly would be irrational based on the

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1 testimony that you've heard to date.

2 The other part of the question
3 that we see that Department of Labor needs
4 to focus on is what population is going to
5 be served by this computer model. Is it
6 going to be 0.2 percent of the IRA
7 population or is this solution intended to
8 address the 90 percent of the employee
9 population?

10 One other issue I would like to
11 raise in the context of this discussion and
12 that point of view is that my entry into the
13 financial world occurred back in 1965. If
14 we were having this discussion in 1965, I
15 don't think anybody would be talking about
16 including mutual funds. The reason I raise
17 that issue is that we need to think forward
18 and not just momentarily. So we need to
19 contemplate the rise in use and application
20 of investment vehicles that could occur in
21 the future that we perhaps see today as mere
22 little drops on the horizon.

23 I'm going to try to fulfill now
24 my second promise and that is to give you
25 three compelling reasons as to why this

1 solution won't work and I'm going to stay
2 away from the notion that we have this
3 infinite list of securities that could be
4 done, but assuming that there is some
5 defined universe and the Department of Labor
6 is capable of defining it. My three reasons
7 come in three categories. First is cost,
8 second motivation and third usage.

9 In terms of costs, I think we've
10 heard today the problem is not writing the
11 logic necessary to come up with investment
12 allocations. The problem is the data. The
13 enormous amount of data that one would have
14 to consider is extremely difficult. We've
15 heard the types of possibilities listed, but
16 I'd like to add to that dialogue the
17 consequence of not including various
18 investments. It really means that
19 beneficiaries are denied possibly what could
20 be the best alternative for them. And again,
21 I'm not talking about today. I'm talking
22 about looking forward in the future where
23 these rules are going to apply.

24 It's also, I think, imprudent for
25 the government to favor one sector over the

1 other and I won't try to explain that
2 anymore. I think that's patently obvious.
3 So the issue of cost I think is a very
4 difficult one.

5 The second which I have not heard
6 discussed this morning is motivation. Let's
7 sit back and think beyond the issue that
8 we're looking at now at the overall picture.
9 What's the goal of financial firms?
10 Clearly, it's to gather assets. The goal of
11 the financial firms are to gather assets.

12 Now what effect does a computer
13 model as described in the statute represent?
14 I maintain that it disburses assets. It
15 says that if I don't in my universe have the
16 best product, then I'm going to send those
17 clients that come to me to someone else.
18 Clearly, it's not in the best interest of
19 the firm. In fact, I would say it's
20 irresponsible for a financial firm to
21 literally run a model that would send
22 clients to some other firm that would
23 benefit from their assets.

24 Basically, unless the tool is in
25 fact biased in favor of some firm, it

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1 doesn't seem to have economic viability.
2 Imagine, for example, if General Motors
3 produced a computer model that selected the
4 best car. It would be very, very difficult
5 for General Motors to say Toyota or Honda or
6 Chrysler makes the best car. That's what
7 we're asking people to do within this
8 construct.

9 It seems to me that no rational
10 firm would voluntarily offer a service or a
11 product that would in fact send customers
12 elsewhere. That's two arguments I've given
13 you.

14 The third argument may well be
15 the most compelling and that has to do with
16 usage. Use of computer models historically
17 has been low. We've discussed and there's
18 lots of discussion that that's going to
19 change over time as we as a society become
20 more computer literate. However, there are
21 some other considerations, I think, relative
22 to computer model usage to date.

23 The first one is the interest on
24 the part of the beneficiary to begin with
25 whether or not this 25 year old beneficiary,

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1 this 30, 40, year old beneficiary is
2 interested enough in their retirement which
3 are several decades in the future to bother
4 with this. This clearly would reduce the
5 number of people who are likely to use the
6 computer model. It's not going to be a
7 majority.

8 The second issue having to do
9 with usage has to do with the fact that the
10 burden on the beneficiary is great. The
11 burden is enormous on the beneficiary when
12 you consider that that beneficiary has to
13 learn a new language. It's a language
14 that's unfamiliar to them. They secondly
15 have to overcome their own instincts which
16 we know to be ineffective in investment
17 terms. And thirdly, they have to go obtain
18 data. They have to understand what their
19 current investments are and this is a task
20 that you're asking somebody who may be
21 marginally interested in their long-term
22 investments.

23 I also want to emphasize that the
24 learning of which I speak is more than
25 academic. We're not talking about learning

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1 facts. We're talking about overcoming
2 emotions. We're talking about feelings.
3 We're talking about learning how to act and
4 behave differently with respect to
5 investments in order to accept the empirical
6 data that one would receive from a computer
7 model. You put those factors together and
8 you say no wonder the usage is low.

9 The question on the table is how
10 much of our IRA population would a computer
11 model as described in the statute actually
12 serve. I maintain that there are other less
13 burdensome solutions that are more desirable
14 than the computer model.

15 I conclude -- My conclusion, I
16 should say, it's not that I'm concluding
17 because I still have another brief section
18 to talk about, but the conclusion we come to
19 is that the only feasible model is from
20 independent advisors that are not funded by
21 either product or transaction forms of
22 compensation.

23 That leaves us with independence
24 and the problem with that is now we're
25 asking the IRA beneficiary to pay yet

1 another party for another service. So we're
2 looking at the expense side as well.

3 Will the computer model solve the
4 problem as stated initially? I think the
5 answer is resoundingly is no. Alternatives,
6 however, are not far away. Our suggestion
7 as presented in our earlier letter is to
8 take advantage of the strengths and the
9 capabilities and the benefits contained
10 within the participant directed plan
11 sponsored plans where there's already a
12 preselected universe that has been
13 prescreened, that has the monitoring and
14 selection process imposed on it. The due
15 diligence is already imposed on it.

16 And we think of two ways of
17 taking advantage of the concepts that are
18 there. One is encouraging and facilitating
19 the use of the employer sponsored plans for
20 IRA assets, in other words, create a
21 structure that would encourage participants
22 or beneficiaries depending on which side of
23 the fence you're starting from to
24 consolidate their investments within the
25 structure of a defined contribution plan.

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1 This would give them advantages and access
2 to fiduciary advisors. It would give them
3 access to qualified default investments.
4 But most importantly, it would give them
5 access to a responsible party acting
6 independently to select and monitor the
7 available investments.

8 The second suggestion that we
9 have that would compliment this would be for
10 those beneficiaries that did not have access
11 to an employer sponsored plan and in that
12 case, we would adopt the QDIA regulation
13 that's forthcoming for IRAs.

14 The QDIA regulations would then
15 have essentially the same rules that you
16 would have within 401(k)s as you'd have in
17 the IRA world which means that the public
18 would only have to learn one set of rules.
19 You wouldn't have dual sets of rules. From
20 an IRA, I have to speak English and if I'm
21 in a 401(k), I speak French.

22 The other requirement I think if
23 we were to do the QDIA route would simply be
24 that we'd have to periodically certify this
25 QDIA structure that would be available again

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1 to a large proportion of participants simply
2 because they're not burdensome. It's a
3 fairly straightforward sort of thing that
4 would be adaptable to participants who are
5 in the low interest categories.

6 With that, I see I have almost
7 run out of time and would end my comments
8 there and invite any questions that you
9 might have.

10 MR. LEBOWITZ: Your last
11 recommendation with regard to QDIA
12 utilization in the IRA context.

13 MR. HARVEY: Yes.

14 MR. LEBOWITZ: I'm not sure I
15 followed you. Are you talking about
16 something where either by statute or some
17 administrative action that participants in
18 IRAs would be limited to a defined set of
19 investment options defined by the
20 government?

21 MR. HARVEY: No, the very
22 opposite and that is to by exemption allow
23 providers to offer a qualified default to
24 their customers that's a prepackaged advice
25 solution that can be reviewed, audited and

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1 certified so that the same qualified default
2 investment option process that one uses
3 within the defined contribution plan
4 replicates that set of rules for IRAs.

5 MR. LEBOWITZ: So the exemption
6 then presumably for the advice that the
7 advisor provides to the participant would
8 only be available to the advisor if the
9 participant invested in one of the qualified
10 default investments.

11 MR. HARVEY: Not quite. I'm
12 suggesting that there are at least two
13 worlds here, one in which there is an
14 independent advisor in which case there's
15 really not much need for an exemption. The
16 other case is where you've got this provider
17 who offers IRA plans. Should that provider
18 not be able to offer to their clients, to
19 their investors, the opportunity to get into
20 qualified default investment and therefore,
21 relieve them of this immense burden that I
22 described before. So you defaulted into a
23 particular investment based on, and I'll
24 just go down the QDIA route, age. It can be
25 a balanced fund. It can be targeted, the

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1 whole nine yards.

2 MR. STRASFELD: Thank you.

3 MR. HARVEY: You're very welcome.

4 MR. STRASFELD: All right. I
5 think we're going to take a break for lunch.
6 Why don't we reconvene at 1:30 p.m.? The
7 cafeteria is closed. That's good and bad.
8 One, there won't be food poisoning, but,
9 two, you can't eat in the building. There
10 are restaurants. Where is that little side
11 street? I think on C Street there's a
12 number of restaurants. Off the record.

13 (Whereupon, at 12:10 p.m., the
14 above-entitled matter recessed to reconvene
15 at 1:33 p.m. the same day.)

16 MR. STRASFELD: Let's get started
17 to we can avoid rush hour. Is UBS present?
18 Is Edward O'`Connor, Joanne Carter or Tammy
19 Boynick. I'm going to go with Edward.

20 MR. O'CONNOR: Good afternoon.

21 MR. STRASFELD: Good afternoon.

22 MR. O'CONNOR: I'm Ed O'Connor,
23 Managing Director of UBS Retirement
24 Services. Joanne Carter is with me in the
25 back and also Peter Rowan, my colleagues.

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1 First, to thank you all for the opportunity
2 to testify today. I have two main points.
3 One is about the role of the financial
4 advisor and secondly, about product
5 innovation, which was touched on I heard a
6 little bit earlier on.

7 But I will be brief, because I've
8 heard many of my points. When you're the
9 ninth to speak, many of the points that I
10 did bring up, were brought up, so in
11 deference to your time, I will be a little
12 fast in some of my testimony.

13 First a little bit about UBS,
14 8,000 financial advisors servicing
15 individuals and entrusted with about 130
16 billion in assets, in IRAs for those
17 individuals, that's about 1.2 million IRAs.
18 Within those IRAs, you've heard already,
19 there's many different types of investments.
20 There's securities, there's properties, we
21 talked about here, financial instruments
22 ranging from CDS to structured products,
23 annuity contracts and so forth.

24 An initial count we did last week
25 for this testimony is in total in all IRAs

1 at UBS 350,000 different types of
2 investments, distinctly different types of
3 investments. And you've heard all that
4 before. Most of the argument I heard today
5 which was arguing for a either perhaps for a
6 computer model or for a more restricted
7 process for IRAs, when I listened to the
8 arguments, they were very much giving
9 examples of a 401(k) participant and there
10 is a difference between a 401(k) participant
11 and a 401(k) account if you will and what
12 that worker has and an IRA and I will get
13 into that a little bit.

14 The typical example you have
15 today of a 401(k) participant, the one we
16 always think about when we're thinking about
17 what's best for a 401(k) program is the
18 young worker who's starting and beginning to
19 first time save for retirement. And most of
20 the time, this young worker doesn't have
21 other assets. This is their nest egg that
22 they're beginning to accumulate over their
23 working life.

24 And of course, the good thing
25 about 401(k)s are if you do move around the

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1 ability to roll over to different 401(k)
2 plans or an IRA is something you can do
3 because of the affordability of working
4 Americans today. But what is interesting
5 later on in life is as that worker ages,
6 more likely he or she has accumulated other
7 assets and when they get close to
8 retirement, and they're thinking of perhaps
9 of rolling into an IRA, if it makes sense to
10 them, you need to begin to consider those
11 other assets. The average American
12 household, one-third of their financial
13 assets and let's be honest, all financial
14 assets for most Americans is about
15 retirement, and one-third of those assets
16 have -- one-third of those assets are in
17 retirement, another two-thirds in stocks and
18 bonds, CDS, annuities.

19 So when you're now in an IRA, and
20 I'm thinking more in the later stages of
21 life, and you're looking at what's best for
22 them, you really should consider their other
23 accounts, if you will. At UBS for every one
24 dollar that we've been entrusted with an
25 IRA, there's another four dollars, a little

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1 different than the average but another four
2 dollars that our clients have with us on
3 average in other accounts. So when our
4 financial advisors are providing advice,
5 they are certainly considering the entire
6 financial picture and as you know, those
7 accounts have obviously a different tax
8 structure to them. Maybe a different time
9 horizon. And some of the dangers, when we
10 talk about how to restrict an IRA, we may be
11 too focused is a nice term, perhaps, maybe
12 too myopic in looking at what's appropriate
13 for an IRA.

14 I heard earlier arguments for
15 let's not include real estate. I actually
16 can talk about situations where a real
17 estate investment does make sense for an
18 individual in an IRA when you look at their
19 full financial picture. And we can talk
20 about that later if you'd like to. Another
21 example, just to give you and I find many of
22 our clients doing this, when they're getting
23 close to retirement, and you are talking
24 about their IRA, but again, they have other
25 assets, is well, let's put more of the

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1 income generating type of investments in my
2 tax deferred IRA and them more investments
3 that are of a capital gains nature and
4 obviously, there's a tax motivation there
5 for the individual, that they're really
6 trying to manages their taxes as best. So
7 another example of how when it's time for
8 the IRA, you really are much more imbedded
9 in the full financial picture of the client.

10 Actually, the final point I have
11 is really what I want to spend the most time
12 on is product innovation. I think actually
13 we are right in the beginning of the
14 unprecedented, if you will, explosion in
15 product innovation that you are beginning to
16 see from the financial services industry and
17 it has to do with the baby boomers. This is
18 the first generation that it's thrust upon
19 them to secure their retirement and baby
20 boomers are expected to live decades past
21 the traditional age of 65.

22 A unique challenge for them is to
23 secure their retirement, generate income for
24 themselves, while at the same time still
25 investing in the markets so inflation

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1 doesn't eat away at their nest egg. And
2 it's a unique challenge. Because of that
3 challenge and from a private sector
4 perspective, you can look at it as an
5 opportunity, you will see more and more
6 types of products that are packaging
7 features together. About a month ago I
8 spoke with former Congressman Bill Thomas
9 and he was interesting because he was, as
10 you may recall, the former Chairman of
11 House, Ways and Means, and he was
12 challenging me, he was challenging UBS and
13 he was challenging the industry.

14 He was saying, "I want to see
15 more", as he called it, "twofers and
16 threefers", and I wasn't sure what he meant
17 by that. But what he was talking about are
18 products that combine the features of
19 investing, the features of some type of
20 protection, principal protection, perhaps,
21 and/or some type of an income guarantee
22 and/or health care features in one product.

23 Some of those are already
24 available today but I think you're going to
25 see more and more of that being created as

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1 time goes on. And, of course, what features
2 the weighing of those features should be
3 different for individuals depending on their
4 wealth, their health and their stage of
5 life. How could a computer model, how could
6 a restrictive process measure those choices
7 in an IRA?

8 And I think my concern is if we
9 do put too many restrictions on an IRA, my
10 biggest concern today is that that product
11 innovation will be hindered and I go believe
12 that's a bad thing if we do that. So that's
13 my main points. I wanted to be a little
14 more brief because most of my other points
15 have been taken. I'm here for any
16 questions.

17 MR. STRASFELD: I thought maybe
18 in some respects, you know, everyone was
19 looking at this too narrowly because this
20 particular statutory exemption is just one
21 way that investment advice could be
22 provided. I mean, we've already stated over
23 the years -- well, obviously, we've come out
24 with our IB on investment education which
25 actually goes a fair amount of way. There's

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1 obviously the SunAmerica approach that we've
2 come out with that's going to a completely
3 disinterested advisor. So, you know, when
4 I'm looking at this, I'm only looking at one
5 particular type of investment advice, you
6 know, depending on how we come out. It will
7 either be through the statutory exemption or
8 through the class exemption that's dictated
9 by the statutory exemption, but it's still
10 only -- it's not really foreclosing
11 investment advice. It's -- you know, I
12 think the investment advice market could
13 undoubtedly grow and there's probably a
14 number of ways you could do it without
15 having to come to us to seek our blessing by
16 exemption.

17 So I assume -- so just -- you
18 know, just to make that point, I assume you
19 seem to be able to view -- you know, I guess
20 just focusing on the narrow question, you
21 are -- I assume are of the view that the
22 full range means everything.

23 MR. O'CONNOR: A full range, the
24 word "everything" is a pretty broad term.

25 MR. STRASFELD: Well, it means

1 more than, I guess, asset classes which is -
2 -

3 MR. O'CONNOR: Yes, I would say
4 that.

5 MR. STRASFELD: Right.

6 MR. O'CONNOR: Where they're
7 concerned about innovation.

8 MR. STRASFELD: Right, I guess
9 may initial rambling is really to -- you
10 know, this -- we're trying to, you know,
11 come to some conclusion but it's in a fairly
12 narrow context and there are obviously,
13 other means of providing investment advice.
14 You know, we've through individual class
15 exemption, methods that are not -- you know,
16 don't per se, run afoul of the risk of
17 further transactions, but I just wanted to
18 clarify that. But you're of the grouping
19 that or the group that concludes that this
20 should be read in a more -- a broader
21 fashion.

22 MR. O'CONNOR: Yes.

23 MR. STRASFELD: All right, let me
24 then -- all right, so if we take that to its
25 -- you know, to its logical conclusion, then

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1 we will conclude that, you know, that we can
2 conclude that there is an IRA computer model
3 available. So I'll ask you, too, as I've
4 asked, you know, some of the other
5 commentators, what would you envision this
6 class exemption that we're supposed to do if
7 we can't make the determination? You know,
8 what would that address or what would it
9 look like?

10 I mean most of the other
11 commentators have said that it should focus
12 primarily on disclosure, but the direction
13 that we seem to be getting from Congress is
14 that it utilized prescribed objective
15 criteria to provide asset allocation
16 portfolios composed of securities. So it
17 doesn't even really necessarily talk about
18 individual holdings. It seems to talk about
19 some sort of collective vehicle which, you
20 know, I'll have to admit I'm not sure
21 exactly what they were getting at.

22 MR. O'CONNOR: Right.

23 MR. STRASFELD: Did you have any
24 views as to -- I mean, obviously, this
25 requirement that's imposed on us or will be

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1 imposed on us, must have some meaning.

2 MR. O'CONNOR: Okay.

3 MR. STRASFELD: I'm just trying
4 to figure out what that meaning is.

5 MR. O'CONNOR: Well, let me
6 answer it maybe a different way because when
7 I think about it.

8 MR. STRASFELD: Yes.

9 MR. O'CONNOR: What really is our
10 intention, I believe, now I'm speaking as an
11 individual here --

12 MR. STRASFELD: Right.

13 MR. O'CONNOR: -- not to
14 Congress. It's about insuring, helping to
15 insure appropriate advice with regard to
16 those IRAs and within that to address
17 potential conflicts and those conflicts
18 could be either outright restricted or you
19 need to disclose loud and clear.

20 MR. STRASFELD: Right.

21 MR. O'CONNOR: I think where
22 maybe the biggest opportunity is, is in a
23 very clear picture of the fees you're paying
24 and what you're paying for. And if I
25 connected that to my point about product

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1 innovation maybe I'll be more clear. It's
2 going to be harder and harder to understand
3 what you're paying for. And if you do break
4 down a product and if it's called an
5 investment product into its basic
6 categories, this could become simple, if we
7 worked on this the right way and it is
8 disclosure, but I think it's a very
9 different way of looking at disclosure.

10 You custody assets, you're paying
11 a firm to hold the money for you and to
12 entrust it for you, so there's a fee for
13 that. It's sometimes very hard to
14 understand what you're paying for that,
15 right? There's a servicing and
16 administration of your investment. There's
17 a statement that comes out once a month,
18 once a quarter. There's a place to make a
19 phone call, ask a question, move the money
20 for you. So there's custody in
21 administration, right.

22 MR. STRASFELD: Oh, yes, we have
23 -- at least we're familiar with that.

24 MR. O'CONNOR: Right. Then
25 there's investments.

1 MR. STRASFELD: Right.

2 MR. O'CONNOR: What are you
3 really paying for that, and then what are
4 you paying -- again, thinking about the
5 future here, what are you really paying for
6 the guarantee, whatever that guarantee may
7 be? And I think we have to start looking at
8 the structure of our disclosure. This can
9 be an opportunity for us. My suggestion is
10 to look at that structure about disclosure
11 for the challenges that are going to be
12 coming forward with regards to new products
13 and new packaging of products. That's my
14 view.

15 MR. STRASFELD: Okay. If people
16 think they're getting something for nothing,
17 they're not.

18 MR. O'CONNOR: Right, absolutely.

19 MR. STRASFELD: All right. Do
20 you have anything, Joe?

21 MR. PIACENTINI: Just one narrow
22 question. You were talking about the
23 importance of looking at the assets outside
24 the IRA, looking more across all the assets.
25 You mentioned consideration of tax

1 implications, tax deferred, taxable
2 accounts. I don't think that's come up
3 earlier today and it's not something that's
4 mentioned in the conditions and statutory
5 exemption.

6 MR. O'CONNOR: Right, yes.

7 MR. PIACENTINI: How important do
8 you think it is to consider tax implications
9 in investment advice? How commonly is it
10 done by advisors or by advice programs?

11 MR. O'CONNOR: Mentioning in the
12 context if we just create a restriction or a
13 process or a model just for the IRA and to
14 look at the IRA and say, does the answer to
15 this IRA make sense, when you step back and
16 look at their whole financial picture and I
17 think I gave an example where why are you
18 only investing in income or into vehicles in
19 this IRA? It doesn't seem appropriate,
20 suitable, but when you step back and realize
21 the individual is choosing from their own
22 tax management standpoint, the individual's
23 choice, right? "Well, I would rather have
24 capital gain types of investments in my
25 taxable accounts".

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1 So when you step back and look at
2 the whole picture, it's appropriate and
3 suitable, but if you begin to just focus,
4 which we did a lot today, on just the IRA,
5 an IRA is much closer to -- by the time
6 they're in an IRA, it's more about all of
7 their assets. I'll give you one more
8 example, maybe this a little more clear.

9 When do you need this money is
10 really one of the most important questions
11 that we ask our clients. When do you need
12 this money, and many times when we talk
13 about this, it's very much in a wealth
14 accumulation mode, "So it's when I retire,
15 age 65, I need X amount of money." Well,
16 what is the type of distribution flows, it
17 would probably be a little more practical if
18 I talked to a client, "But when do you need
19 this money? Is it the same amount of money
20 each and every year?"

21 And then you get into
22 conversations about their house. "Oh, you
23 plan on selling the home. Okay, well, maybe
24 then your time horizon for needing this IRA
25 is a little bit further down the road if

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1 you're selling your home. What kind of
2 health care coverage do you have? All
3 right, is your health care coverage
4 sufficient for you for the rest of your life
5 or do we have to think about those costs
6 perhaps later in your retirement years
7 because perhaps medical costs very likely
8 will grow in the second half".

9 So example of a taxed account or
10 not taxed account or the house is all about
11 -- when you're talking about an IRA, now
12 you're really talking about a person that's
13 getting, generally speaking, closer to
14 retirement and it's about everything they
15 have and how to best manage their money for
16 their retirement.

17 MR. STRASFELD: Thank you very
18 much.

19 MR. O'CONNOR: Thank you, Mr.
20 Strasfeld.

21 MR. STRASFELD: PENSCO?

22 MR. ANDERSON: Good afternoon.
23 Thank you for the opportunity to speak today
24 on behalf of the American public, the self-
25 directed IRA industry and PENSCO Trust.

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1 PENSICO Trust is a \$2.2 billion dollar self-
2 directed IRA custodian operating as a bank
3 and trust. And I'd like to agree with a lot
4 of the comments I heard today and disagree
5 with some others. The first thing I would
6 say --

7 MR. STRASFELD: Could you
8 identify yourself?

9 MR. ANDERSON: My name is Tom
10 Anderson.

11 MR. STRASFELD: Thank you.

12 MR. ANDERSON: The first thing
13 I'd like to say is, I think that the
14 Department of Labor has a very untenable
15 position in this regard. I think it's clear
16 from most of the speakers and I would
17 concur, that a model is impractical. That
18 being the case, your left with the choice of
19 coming up with an exemption for a class of
20 individuals that will potentially created an
21 institutionalized self-dealing situation
22 because these are not independent financial
23 advisors but advisors that are associated
24 with firms that sell proprietary products.

25 So that's a very difficult

1 situation. I don't believe that such a
2 class exemption has been granted since the
3 IRC-4974 code was devised and I would
4 suggest possibly another alternative which
5 would be to suggest to those firms that have
6 proprietary products that they find a way to
7 develop more independent advisors within
8 their own groups. Because if you look at an
9 independent advisor today, since they're not
10 compensated based on the investments that
11 they choose for their clients, looking at
12 the client from a holistic standpoint,
13 they're going to more theoretically follow
14 the modern portfolio theory which is to
15 include in the portfolios of their clients
16 assets that are not highly correlated.

17 And I can say for being in the
18 business that I'm in that thousands of our
19 clients over the last five years during the
20 market down-turn, the scandals in the
21 securities industry and the mutual fund
22 industry, people were dying to get out of
23 their 401(k) defined benefit -- defined
24 contribution plans and out of their
25 traditional IRAs to into alternative assets

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1 and those that did, did quite well, not to
2 say that, you know, in two years the stock
3 market will decline by 20 percent and the --
4 I'm sorry, the real estate market will
5 decline by 20 percent and the stock market
6 go up 20 percent, but those two asset
7 classes alone and there are hundreds of
8 asset classes, are not correlated and
9 therefore, a given portfolio over the last
10 five years equally balanced between real
11 estate and the stock market no matter
12 virtually what you chose within those two
13 markets, would have probably been ahead
14 overall in terms of value.

15 \$1.7 trillion was lost in
16 retirement accounts from 2000 to 2005 mainly
17 because of systematic risk and that's
18 because IRAs were stuck in traditional
19 assets or retirement assets were stuck in
20 401(k)s with a limited set of choices. So I
21 would suggest that high risk, which that
22 being the backdrop and with the Enron
23 situation and with other things that are
24 included in the Pension Protection Act of
25 2006 would suggest that they want more self-

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1 directing. They want more choices for
2 retirees and pre-retirees and their
3 investment choices, including the fact that
4 they have a provision now that says that you
5 can't just offer a single company stock as a
6 part of the plan. You have to offer at
7 least three other mutual funds and also
8 you're permitted to include alternative
9 assets.

10 It does put in place to get out
11 of the situation when people are locked into
12 a down market. So you can't, I think, doing
13 duty to the American public, suggest that
14 there can be a class exemption that's for
15 advisors that limit the assets their clients
16 can choose for IRA investments to a limited
17 set of investors. It's in conflict with the
18 IRC-408 Code which suggests there's only two
19 asset classes you can invest in,
20 collectables and life insurance. It's also
21 in conflict with all the other provisions
22 that are promoting more self-directing and
23 more liberalization of IRA rules inherent in
24 the Prevention and Protection Act.

25 If you look at the largest

1 pension fund in the United States, \$249
2 billion, 37 percent of that fund currently
3 is allocated in alternative investments. So
4 there's a reason for that, because those
5 investments do not correlate with the stock
6 market and so there's a hedge against other
7 asset classes. So to suggest to IRA holders
8 they can no longer, you know, buy real
9 estate or by private equity, that's going in
10 the wrong direction. I think it's also
11 going in the wrong direction that the
12 Congress is trying to signal.

13 They were trying to say all are
14 permitted investments within the IRA rules.
15 Now, that may be impractical but to suggest
16 to restrict that is going the other way or
17 to suggest let's eliminate IRAs, I think
18 that's political suicide if you're in
19 Congress to go back to your constituents and
20 say, "You no longer have control over your
21 IRA and you're going to have to roll it back
22 into a 401(k) and we're going to limit it to
23 a small set of assets".

24 A couple other things that people
25 should be aware of, I think is the overall

1 trend with people now living longer and
2 realizing that they have to manage their
3 retirement portfolio over a longer period of
4 time, as the gentleman from UBS just stated,
5 they're going to have to manage this from an
6 investment standpoint. This is no longer a
7 fixed instrument kind of deal where you just
8 lock it up. They're going to live longer
9 and need 20 years of financial resource
10 after age 65. So they have to actively
11 manage this account and grow it, because the
12 bottom line, IRAs would not exist at all if
13 it wasn't for the fact that they give tax
14 deferred or tax-free compound growth.

15 So the last thing you want to tap
16 is your IRA and you want to be actively
17 involved in managing it and more and more
18 boomers who are relatively more
19 sophisticated, now want to be out of the
20 limits that are experienced in 401(k)s and
21 traditional IRAs. If you look at the
22 average balance sheet according to the
23 Census Bureau and the Department of Labor
24 statistics of 2001, the per capita balance
25 sheet shows that approximately 39 percent of

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1 the average American's balance sheet is
2 invested in real estate or composed of real
3 estate. Seven percent is composed of
4 private equity and only 18 percent in the
5 stock market, mutual funds, bonds, and that
6 includes IRA monies invested in those
7 categories.

8 So it's inconsistent that IRAs up
9 to this point have been restricted into the
10 traditional arena. They should be allowed
11 to do everything that's allowed under code
12 in 408 and we see more and more of those
13 trends. PENSCO, as a company, is growing in
14 our industry. We're a member of the
15 Retirement Industry Trust Association and
16 we're growing at approximately 20 percent
17 within the \$4.2 trillion IRA market whereas
18 the overall IRA market is only growing at
19 eight percent.

20 Merrill Lynch did a recent study
21 that indicated that 75 percent of the people
22 that are retiring are rolling out of their
23 defined contribution plans into IRAs
24 presumably because they want to take more
25 control over their investment. So any

1 suggestion to limit the set that an advisor
2 can choose from, I think, is ill-founded.
3 Not to say that many people don't need
4 advisors, and I would suggest that unless a
5 model can be devised or a set of controls
6 and audit procedures to insure that any
7 financial advisor that's associated with a
8 proprietary product company has to
9 incorporate other asset classes would be
10 inappropriate. It would be basically
11 institutionalizing a violation of IRC-4975
12 because they'd be pushing people into assets
13 that they've compensated for selling.

14 So to conclude, I would suggest
15 that, number one, I agree with the majority
16 of people who have spoken earlier that
17 suggest that a model is just impractical. I
18 think that if you could come up with a model
19 as everybody would envision, you wouldn't
20 have a need for financial advisors, so that
21 would eliminate the exemption requirement.
22 But it's just not going to happen. I mean,
23 you have people here representing companies
24 that have models saying that's not going to
25 happen. So the question is, how can you do

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1 service to the American public to insure
2 that self-dealing will not exist when you
3 grant this exemption and that's through
4 proper controls procedures guidelines as to
5 asset allocation.

6 Following more of the minor
7 portfolio theory incorporating alternative
8 asset classes. I'm done.

9 MR. STRASFELD: All right. Well,
10 I'm somewhat confused by your testimony.

11 MR. ANDERSON: Sure.

12 MR. STRASFELD: If you conclude
13 on the one hand that there is no model,
14 which other people have stated, that's fine,
15 but then you've gone a step further and said
16 that there's no exemption we should do
17 because it would encourage self-dealing
18 because the advisors who are the subject of
19 the exemption would put IRAs into products
20 for which they receive compensation. So if
21 we're not doing the exemption and we're not
22 doing the model, then what are we doing?

23 MR. ANDERSON: As I suggested, I
24 think you're in an untenable position. I
25 think that the --

1 MR. STRASFELD: That's right,
2 that was the start.

3 MR. ANDERSON: I think Congress
4 intended you to liberalize what restrictions
5 there have been on retirement accounts
6 coming off of all of the problems over the
7 2000, you know, period through 2005 when
8 there was a systematic drop in the market
9 that period had their retirement accounts
10 in. They've heard from their constituents
11 saying, "We want more liberalized choices".
12 So that's the signal. However, I don't
13 think they maybe thought through the
14 practicality of coming up with a model like
15 that to prevent, almost like a protective
16 advice, prevent self-dealing.

17 MR. STRASFELD: What limitations
18 are you talking about, because it seems to
19 me under the Code IRAs can't invest in
20 collectables, but under out provisions and
21 under the Code, they can pretty much invest
22 in anything they want.

23 MR. ANDERSON: No, I'm just
24 suggesting that if you get a class
25 exemption, about 97 percent of all IRAs are

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1 offered by companies that have proprietary
2 interest in the products they sell.

3 MR. STRASFELD: Oh, sure, sure.

4 MR. ANDERSON: And if you give an
5 exemption to advisors that are going to
6 suggest to people what they invest in and
7 they're compensated for suggesting that they
8 go into their products, then it's going to
9 be very difficult to make sure that there is
10 some objectivity in that advice.

11 MR. STRASFELD: Now, is there --
12 right, which I don't necessarily disagree,
13 but is there -- besides disclosure, is there
14 something else that we could put in an
15 exemption that would assure more objectivity
16 to know they may be paid for the products
17 they're advising?

18 MR. ANDERSON: Well, I don't have
19 the magic wand on this one. I think
20 everybody probably would have a different
21 opinion on what you could do, but I would
22 just suggest that maybe there's some balance
23 between having a totally fee-based financial
24 advisor that's totally objective and not
25 compensated by a proprietary firm and a

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1 proprietary financial advisor. Maybe they
2 have some guidelines to go beyond the
3 proprietary products. Maybe there's a limit
4 as to what percentage -- even if it's 75
5 percent, some limit to say there is a
6 stopgap, you can't sell more than 50 percent
7 of our products or advise. I don't have the
8 solution.

9 MR. STRASFELD: In the absence of
10 an exemption or a model, is there anything
11 else that would be available to IRAs other
12 than, I guess, a fee based advisor?

13 MR. ANDERSON: No, but a lot of
14 the firms that are represented here, I know
15 have independent advisors associated with
16 them and many of those are doing the full
17 diversification and others that are more
18 narrow firms in terms of products they offer
19 don't. I don't know how to bridge that gap.

20 MR. STRASFELD: Anyone else.

21 MR. ANDERSON: Thank you.

22 MR. STRASFELD: Thank you.

23 Ameriprise Financial, Inc. Scott Plummer?

24 MR. PLUMMER: Right.

25 MR. STRASFELD: All right, good.

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1 MR. PLUMMER: Good afternoon. My
2 name is Scott Plummer and I am Chief Legal
3 Officer for RiverSource Investments, the US
4 based asset management subsidiary of
5 Ameriprise Financial. With me today is Kurt
6 Lofgren, counsel to our Retail Retirement
7 Unit. I won't begin my remarks with a
8 comment about height other than to say, like
9 the speakers you've heard today, Americans
10 come in all shapes and sizes. I know I'm
11 stating the obvious here and I believe that
12 all participants in this process want to
13 achieve the outcome that gives the largest
14 number of Americans the opportunity to
15 satisfy their retirement needs and so
16 hopefully you will hear that theme within
17 our remarks today.

18 To begin, I'd like to mention
19 that I've worked in the asset management
20 industry for 14 years and have witnessed the
21 technology enhancements that have occurred
22 for many companies including RiverSource
23 Investments, which have been implemented to
24 drive consistent, competitive performance
25 and improve overall risk management.

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1 Computer models have played and
2 continue to play an important role in the
3 development of retail financial services
4 products and have significantly improved
5 asset allocation strategies available to
6 individual investors. In addition,
7 Ameriprise Financial, the parent company of
8 RiverSource Investments, is a leading
9 financial planning and advice company with
10 more than 10,000 financial advisors
11 throughout the United States, offering asset
12 accumulation, income, banking and protection
13 solutions to help clients achieve their
14 dreams.

15 With that as a background, I'd
16 like to turn to the topic of today's
17 meetings, computer models' ability to meet
18 the advice needs of Americans investing in
19 Individual Retirement Accounts. The
20 Pensions Protections Act's advice provisions
21 are intended to expand access to advice for
22 Americans planning for a retirement. We
23 strongly supported the legislation signed
24 into law last year. In terms of investment
25 advice the PPA struck an unusual compromise

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1 that we've discussed quite a bit today. The
2 Department must determine the feasibility of
3 a computer model to provide investment
4 advice that meets explicit statutory
5 standards including whether it is able to
6 take into account the full range of
7 permissible investments including equities
8 and bonds in determining the investment
9 options for an IRA account.

10 I'd answer one of the questions
11 from our perspective, that's been asked
12 quite a bit today. I'm from the Midwest and
13 when I read "take into account the full
14 range of permissible investments", at one
15 level that's what I read and that's what I
16 think that the legislation was intended to
17 drive. A couple of other levels of response
18 to that question is the -- as you move up to
19 more general -- a grasp of more general
20 categories, so asset classes, obviously, the
21 credibility of the computer model is
22 diminished by the fact that you don't have
23 the specific data underneath that's been
24 tested and validated and again to state the
25 obvious, the more general the output, the

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1 more general the advice that's provided. So
2 to be clear, we do not believe such a model
3 is feasible.

4 In our view, computer models
5 cannot take into account the full range of
6 investments available to IRA beneficiaries
7 and do not allow IRA beneficiaries
8 sufficient flexibility to consider personal
9 relevant financial information in obtaining
10 advice. Importantly, we believe the best
11 public policy would be to provide a
12 disclosure based class exemption as the best
13 means to help insure greater access to
14 meaningful professional advice.

15 At RiverSource Investments we
16 have developed a number of highly
17 sophisticated and effective quantitative
18 investment models that generally fall into
19 one of three categories; asset allocation,
20 security selection and investment
21 optimization. These are used by our
22 institutional investors as we seek
23 consistent competitive performance over time
24 but are not designed for direct use by IRA
25 beneficiaries or their clients.

1 Our proprietary asset allocation
2 models have the ability to allocate assets
3 across more than 20 asset categories
4 including many but not equities and bonds.
5 While very highly sophisticated, these
6 models do not cover the full range of
7 permissible investments for an IRA since the
8 universe of permissible IRA investments is
9 virtually limitless due to the dynamic
10 nature of today's financial markets as we've
11 heard quite a bit today. On this basis, the
12 practicalities of obtaining the necessary
13 amount of data for this universe of
14 investments in order to develop and maintain
15 an all-encompassing model makes it
16 unfeasible, if not impossible, to implement.

17 In addition to take into account
18 all of the investments available with an
19 IRA, the PPA also requires the computer
20 model to allow the IRA beneficiary with
21 sufficient flexibility in obtaining advice
22 to evaluate and select investment options.
23 In our view, today's computer models do not
24 provide IRA beneficiaries with sufficient
25 flexibility to alter the advice provided by

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1 the computer model to suit their individual
2 financial information. Due to the
3 intellectual rigor and scientific validation
4 dedicated to developing the logic and
5 assumptions that drive the most effective
6 computer models, we do not foresee a
7 meaningful ability for an IRA beneficiary or
8 even a well-trained financial advisor to
9 materially modify a model. In fact, we
10 believe that such manipulation would likely
11 corrupt the very integrity of the model
12 itself. At most, variations to any model
13 are limited to a handful of inputs
14 reflecting external variables such as the
15 age of the IRA beneficiary.

16 Although computer models cannot
17 meet the statutory requirements set forth
18 within the PPA, computer models can be very
19 useful tools for IRA beneficiaries and
20 financial advisors. However, in order to be
21 most used effectively, we believe they
22 should be implemented in conjunction with
23 the comprehensive and personalized advice
24 capabilities of a knowledgeable financial
25 advisor, with the results evaluated in the

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1 context of the IRA's beneficiary's entire
2 financial situation.

3 At Ameriprise Financial we have
4 more than 2.7 million individual,
5 institutional and business clients. Our
6 core focus is on the mass affluent and above
7 in the US market which represents more than
8 41 million US households. Many of these
9 individuals are members of the baby boom
10 generation that have an unprecedented
11 opportunity to shape their retirement years
12 around their dreams and goals. Our clients
13 represent a cross section of America, the
14 traditional employed worker, the self-
15 employed, the small business person, and
16 they each have unique financial needs.

17 Our clients select and maintain
18 IRA accounts with us principally because
19 they want the help of a personal financial
20 advisor. Our clients can invest in several
21 different IRA products. The majority of our
22 clients' IRA assets are held in brokerage
23 accounts with Ameriprise Financial Services,
24 Inc., our broker/dealer affiliate. IRA
25 beneficiaries can select from thousands of

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1 different mutual funds. In addition,
2 clients can hold publicly traded stocks and
3 bonds, certain options, real estate
4 investment trusts, and union investment
5 trusts within their IRA. We also offer
6 individual retirement annuities and IRAs
7 that hold face amount securities which is a
8 product somewhat unique to Ameriprise
9 although it is similar in many respects to a
10 Certificate of Deposit.

11 Over half of our IRA assets are
12 held in fee-based RAP accounts. While we
13 have a broad product sweep, we do not offer
14 certain other investments that could
15 otherwise be held within an IRA, such as
16 certain precious metals, direct real estate
17 holdings, or privately held stocks. Our
18 clients seek investment advice as to which
19 types of IRAs to select, the investment
20 structures within the IRA, the allocation of
21 their assets and the most effective
22 withdrawal strategy, all within the context
23 of a comprehensive financial plan. Given
24 the breadth of investment choices available
25 to IRA clients, a limited scope computer

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1 model would be of little value to them.

2 Instead we believe that the
3 financial planning process is the most
4 effective way of our IRA clients to manage
5 their finances and prepare for the future.
6 Our financial advisors are subject to
7 oversight by several government agencies and
8 self-regulatory organizations including the
9 DOL, the SEC, the NASD and various state
10 agencies. Our advisors offer financial
11 planning consistent with the Certified
12 Financial Planner Board of Standards. After
13 the advisor has been engaged by the client
14 and gathered the relevant personal financial
15 data, our advisors have access to numerous
16 tools that help them analyze the client's
17 financial situation and make asset
18 allocation recommendations unique to that
19 client.

20 These tools help the advisor
21 evaluate the client's finances holistically,
22 favoring the impact of taxation protection
23 and other goals at an asset class level.
24 Advisors then have access to several
25 investment selection resources, including

1 research tools from Morningstar to compare
2 and contrast potential holdings within each
3 asset class as well as continuously updated
4 fact sheets with respect to certain
5 investment options.

6 Our clients, however, are not
7 unique in terms of their interest in
8 obtaining professional assistance in the
9 management of their retirement assets. For
10 example, a 2007 Spectrum Group study found
11 that among both baby boomers and World War
12 II generation, 67 percent used a
13 professional financial advisor in deciding
14 whether to roll retirement plan balances
15 into a personal IRA. A 2007 Forrester
16 Report found that for every generation
17 financial advisors are considered the most
18 helpful resource in retirement research.
19 And in 2004 the Roper study we commissioned
20 found that clients with an advisor save
21 almost twice as much for retirement.

22 Your decision to issue a broad
23 disclosure based exemption would enable our
24 clients and many other IRA investors to
25 receive the advice they need to help them

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1 effectively manage their IRA savings over a
2 lifetime. There are a number of exemptions
3 and advisory opinions that provide some
4 avenues for the provision of investment
5 advice. However, much of this guidance was
6 issued in the 1970s and 1980s before the
7 development of today's robust IRA market.
8 We feel strongly about the need for a broad
9 IRA advice exemption rather than a patchwork
10 of nuance positions. The latter framework
11 is extremely difficult to communicate to a
12 financial service provider's field force
13 much less to clients when they request
14 assistance in managing their IRA accounts.
15 As the Department moves forward to consider
16 a class exemption, there should be no doubt
17 that if the conditions are met, the
18 fiduciary advisor will not be engaging in a
19 prohibitive transaction by providing
20 investment advice to the IRA beneficiary.

21 The statute already provides for
22 significant conditions relating to providing
23 investment advice. Most importantly, this
24 exemption does not alter the standard of
25 care required on the part of the advice

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1 giver. In fact, as the term implies, the
2 fiduciary advisor is considered to be a
3 fiduciary and must acknowledge this fact.
4 As a fiduciary, the advisor must act in the
5 best interests of her or his client.
6 Additional considerations include the
7 disclosure of fees and conflicts, obtaining
8 prior written consent of the IRA
9 beneficiary, receipt of more than -- of no
10 more than reasonable compensation.

11 The transaction must be arm's
12 length. The advice must be non-
13 discretionary and the records must be
14 retained for six years. The statute also
15 includes an audit requirement but leaves the
16 details of such an audit to the discretion
17 of the Department. It is our opinion that
18 these requirements, which would be in
19 addition to requirements already in place by
20 other securities regulators, will protect
21 the interests of IRA beneficiaries. In that
22 regard, we would request that the Department
23 coordinate its guidance regarding the
24 disclosure and audit requirements to take
25 into account requirements already in place

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1 for certain fiduciary advisors. We believe
2 a coordinated approach provides better
3 synergistic benefits for regulators, while
4 allowing the fiduciary advisor to focus on
5 one set of integrated compliance
6 requirements.

7 A registered investment advisor
8 is required to disclose the nature of its
9 business, compensation arrangements,
10 affiliation of other entities, disciplinary
11 history, and any other conflicts of interest
12 it may have. Such disclosure is found in
13 the advisor's form ADV or brochure. Similar
14 to the Investment Advice Exemption under the
15 PPA, the purpose of the disclosure
16 requirements under the Advisor's Act is to
17 protect investors. Therefore, we believe
18 that the same level of disclosure is
19 appropriate here. The PPA requires
20 disclosure, past performance and historical
21 rates of return for investments available to
22 the plan. This requirement may work for
23 IRAs where investments have been limited by
24 the company sponsoring the IRA. However, as
25 just been mentioned previously, where the

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1 IRA sponsor utilizes open architecture
2 through a brokerage account, this
3 requirement would be difficult or impossible
4 to meet. A practical approach would be to
5 require the past performance and historical
6 rates of return be made available upon
7 request.

8 In closing, we believe it's not
9 feasible for a computer model to meet the
10 statutory requirements of the Act and
11 request that you move quickly to issue a
12 disclosure based exemption. Thank you for
13 this opportunity to testify today. The IRA
14 Investment Advice Exemption is very
15 important not only to our clients and our
16 company but to all the Americans as they
17 pursue financial independence during
18 retirement.

19 MR. STRASFELD: Okay, thank you
20 very much.

21 MR. JOHANSEN: I was
22 misintroduced at the beginning.

23 MR. STRASFELD: What is the
24 correct name?

25 MR. JOHANSEN: Kurt Johansen.

1 Lofgren is our chief counsel.

2 MR. STRASFELD: All right.

3 MR. TRONE: Are we taking an
4 official transcript today?

5 MR. STRASFELD: Yes.

6 MR. TRONE: Then I'd like to
7 suggest that maybe we move to a bigger room
8 to accommodate the standing room audience
9 that we have.

10 My name is Don Trone and I am the
11 President of the Foundation for Fiduciary
12 Studies and the founder of Fiduciary 360. I
13 have more than 20 years of experience in
14 publishing and developing fiduciary training
15 programs and software which support the
16 decision making process of investment
17 fiduciaries. The mission of the Foundation
18 for Fiduciary Studies is to define and
19 promulgate prudent practices for investment
20 fiduciaries and a series of fiduciary
21 handbooks have been written for the
22 investment industry on these practices and I
23 have two of those handbooks with me today.
24 One is "The Prudent Practices for Investment
25 Stewards". The second is "The Prudent

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1 Practices for Investment Advisors", and I'll
2 leave these with the staff.

3 All of the fiduciary practices in
4 these handbooks have been substantiation by
5 regulations, case law and regulatory opinion
6 letters. The legal memorandum that
7 accompanied these fiduciary practices were
8 prepared by the ERISA law firm of Reich,
9 Luftman, Reicher and Cohen. A copy of the
10 legal memorandum is provided as well. In
11 turn, the Foundation's fiduciary practices
12 are used extensively by Fiduciary 360 which
13 coordinates the resources for the Center for
14 Fiduciary Studies and Fiduciary Analytics.
15 The Center for Fiduciary Studies provides
16 fiduciary training programs and awards the
17 professional designations accredited
18 investment fiduciary and accredited
19 investment fiduciary analyst. More than
20 5,000 professionals have undergone one or
21 more of these fiduciary training programs.

22 Fiduciary Analytics is an
23 applications development firm building
24 sophisticated online tools for trustees and
25 investment professionals based on the

1 fiduciary practices defined by the
2 Foundation. In fact, today we have more
3 than 1200 financial services firms using
4 these fiduciary based tools including many
5 of the people that provided testimony today.
6 The Foundation's practices have also been
7 adopted by CEFEX, which is a global
8 independent assessment and certification
9 organization. CEFEX works with the
10 investment and fiduciary communities to
11 provide comprehensive assessments that
12 measure risk and trustworthiness of
13 investment fiduciaries.

14 The assessment procedures that
15 have been developed by CEFEX are based on
16 ISO 19011 which is a global auditing
17 standard, and are similar to other industry
18 assessment procedures such as SAS 70 and Six
19 Sigma. We've identified two pre-
20 suppositions to the discussion of computer-
21 driven advice models. First, and I think
22 it's already been addressed by most of the
23 other previous speakers, it's not just about
24 developing an asset allocation solution.
25 It's about a comprehensive investment

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1 management process. And whether we're
2 talking about a process that's associated
3 with the computer model or an investment
4 advisory service that's been suggested by
5 several of the other speakers, it's still
6 about an investment management process.

7 In our opinion, the availability
8 of appropriate technology is not a
9 challenge. The challenge for the Department
10 is to define the fiduciary practices and
11 rules that will drive the technology. With
12 fiduciary rules based technology and those
13 are the operative words, fiduciary rules
14 based technology, the investment industry
15 will be fenced within a defined level
16 playing field and a Department regulator and
17 auditors will be able to quickly identify
18 the players who are out of bounds, which
19 leads to our second pre-supposition.

20 It's still about procedural
21 prudence. ERISA was designed to be a
22 flexible doctrine that gives consideration
23 to incorporating changes in the types of
24 financial products made available to
25 investors as well as evolving investment

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1 strategies and theory, Lew Harvey's comment
2 earlier today about mutual funds in 1965.
3 At the root of the doctrine is the concept
4 of a process standard and the requirement
5 that investment decision makers demonstrate
6 the procedural prudence. Now, I'm not an
7 ERISA attorney but I would suggest maybe the
8 Department to back and look at ERISA Section
9 404(a)(1)(b) as the answer to your question,
10 Mr. Stratsfeld, beating you to the punch,
11 what is the appropriate universe of
12 investment options.

13 The appropriate universe are
14 those investment options where the
15 investment decision maker can demonstrate
16 the procedural prudence in the selection of
17 each and every investment option. Your
18 answer might be as simple as Department re-
19 emphasizing the need to demonstrate the
20 procedural prudence and the selection of
21 each investment option. Going to the
22 comment that was made this morning by the
23 Securities Industry and Financial Markets
24 Association, talking about the policies and
25 procedures at the institutional level. We

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1 concur with that provided that those
2 policies and procedures define a fiduciary
3 standard of care for the conduct of their
4 investment advisors.

5 To assist the Department in
6 developing the fiduciary rules to be used in
7 the computer advice model, and again,
8 whether we're talking a model or individual
9 investment advice as has been suggested by
10 several of the speakers, and to define the
11 procedural prudence associated with the
12 investment decision making process, we would
13 recommend that the Department form a
14 separate advisory council, similar to the
15 Department's ERISA advisory council, to
16 periodically meet to suggest inputs for the
17 technology.

18 And I'd like to use the remainder
19 of my time to demonstrate one example of
20 fiduciary rules based technology that we
21 have developed. This particular tool is
22 called the Fund Analyzer. By way of some
23 background, investment fiduciaries have a
24 responsibility to establish a due diligence
25 process for selected investment options and

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1 on ongoing duty to monitor the implemented
2 strategy. This is of particular importance
3 to affiliated investment advisors of service
4 vendors who may be recommending a
5 proprietary fund of the service provider.

6 More than eight years ago, we
7 published for the industry what we believed
8 to be the minimum due diligence process that
9 a fiduciary should demonstrate when
10 selecting and monitoring an investment
11 option. The minimum due diligence process
12 consists of nine fields and with each field
13 we have also identified a threshold that
14 must be met to demonstrate conformance and
15 this information is summarized in
16 illustration number one.

17 In fact, if you look at
18 illustration number one, you'll see that the
19 first field of due diligence is that we
20 suggest that the investment option come
21 under regulatory oversight. In other words,
22 the investment option is part of a regulated
23 entity such as an investment option that is
24 managed by a bank, an insurance company, a
25 registered investment company or a

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1 registered investment advisor.

2 In January 2001, we launched the
3 online version of our technology that
4 applies the due diligence process to a
5 universe of mutual funds and separately
6 managed accounts. The Fund Analyzer maps
7 the minimum fiduciary due diligence process
8 to readily available databases, the
9 Morningstar universe of 16,000 open end
10 mutual funds being our primary source. In
11 other words, we take the due diligence
12 process that we talk about in Illustration
13 Number One, and we map it to all 16,000
14 funds in the Morningstar universe.

15 In turn, we weigh each field of
16 the fiduciary due diligence process and its
17 relative importance to a fiduciary's
18 decision making process. Using the weighted
19 factors and ranking the results relative to
20 peers, we determine an overall fiduciary
21 score. There are five classifications of
22 fiduciary scores which are also color coded
23 to facilitate reviews by investment
24 decisions. The color coding makes it so
25 simple even a -- and you can fill in the

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1 blank. This information is displayed in
2 Illustration Number Two.

3 Our technology then provides the
4 investment decision maker a number of
5 different formats to present the information
6 to a client and to review the details behind
7 the fiduciary score. In other words, we
8 believe in full transparency. It's not
9 enough to simply say what the fiduciary
10 score is, but also give the details of what
11 made up that particular score. Some of the
12 sample reports, the first is the fiduciary
13 score sheet. This provides the decision
14 maker a flash report of what's working and
15 what's not. I call it the bench strength.
16 It's as simple as putting the ticker in of
17 an investment option or tickers in a
18 portfolio and you come back with this
19 fiduciary score sheet.

20 In the first column, you see the
21 fiduciary score for the current quarter of
22 each investment option, in the second
23 column, the three-year average. The next
24 level of detail is called the plan summary.
25 We provide the decision maker more detailed

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1 information about each investment option.
2 It continues with the color coding but also
3 compares the rolling performance of each
4 investment option to its peer group and
5 relative index, which is consistent with
6 current ERISA case law.

7 Illustration Number Five is the
8 fiduciary score due diligence breakdown
9 which provides the decision maker a
10 pass/fail analysis of each of the due
11 diligence criteria. Illustration Number Six
12 is the fund profile which provides the
13 decision maker a very detailed analysis of
14 each field of the due diligence process and
15 a comparison to a defined threshold. So
16 when you look at this Illustration Number
17 Six, all nine fields of that due diligence
18 process now with their threshold are
19 displayed in the one profile.

20 And any time a field of
21 information has a shortfall to the
22 threshold, that field of data is shaded in
23 gray so that visually, you're alerted to
24 what the fiduciary shortfall is with each
25 investment option. Illustration Number

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1 Seven provides the decision maker a detailed
2 analysis of the consistency of a particular
3 investment option, so you can go quarter by
4 quarter back over the last five years to see
5 what the fiduciary score has been. And then
6 finally the last illustration which is my
7 favorite, provides the decision maker a
8 narrative, plain English narrative, of the
9 fiduciary shortfalls of a particular
10 investment option and provides the
11 investment advisor the opportunity to add
12 their own observations to the report. And
13 then along side the investment advisor's
14 recommendation there is the capacity to
15 record the client's direction to either
16 place the fund on a watch list or replace
17 it.

18 Thank you.

19 MR. STRASFELD: What would be an
20 example of the so called shortfalls in terms
21 of analyzing an investment? I mean --

22 MR. TRONE: Sure. Some of the
23 more prominent ones, the expense ratio of
24 the investment option. We have a fiduciary
25 duty to control and account for investment

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1 expenses, but as an industry, we've never
2 drawn the line in the sand to say expense
3 ratios on this side of the line are
4 reasonable, the other side of the line are
5 not. And so what the technology will do, it
6 will take a peer group and rank all the
7 expense ratios of that peer group, cheapest
8 to most expensive. We believe the threshold
9 is at the 75th percentile. That if the
10 expense ratio of an investment option is in
11 that bottom quartile, that most expensive
12 quartile, a fiduciary is going to have a
13 very difficult time defending themselves
14 against a charge that they're prudently
15 managing fees and expenses. That would be
16 one illustration.

17 Another would be manage your
18 tenure. You know, at what point do we say
19 the same portfolio management team should be
20 in place to be worthy of a fiduciary
21 consideration? And then in turn from a
22 monitoring standpoint, what does that say
23 when we're worrying about the departure of a
24 key portfolio manager? This type of
25 reporting will pull out all those key

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1 factors.

2 MR. STRASFELD: And I assume
3 performance factors enter into that somehow?

4 MR. TRONE: Yes, performance is
5 one, three, five year performance ranked
6 against the peer group, also risk adjusted
7 performance, we look at the chart and also
8 compare it against the peer group.

9 MR. STRASFELD: All right, so a
10 lot of these are peer group comparisons; is
11 that right?

12 MR. TRONE: Yes, yes. Yes, the
13 history behind this actually was a project,
14 Don Phillips, the managing director of
15 Morningstar asked me to do about eight and a
16 half, almost nine years ago. He said,
17 "More and more 401(k) trustees are relying
18 entirely upon Morningstar data to select
19 their investment options. What if one of
20 these trustees ran into difficulty with an
21 auditor or a litigator? Would they be able
22 to substantiate or demonstrate their due
23 diligence, their prudence by relying solely
24 upon Morningstar data?" So if you're
25 familiar with the Morningstar software,

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1 Principia Pro, you open it up and you see
2 158 fields of information. All right,
3 you're the Department of Labor and I'm a
4 401(k) trustee or I'm an investment advisor
5 with an IRA rollover and I call you and I
6 say, "I've opened up Principia Pro. I'm
7 looking at 158 fields of information.
8 What's the first field of information the
9 Department of Labor wants me to look at,
10 what's the second and the third"?

11 MR. STRASFELD: Based on the
12 request, I'd have to see fees, but I'm
13 speaking for myself.

14 (Laughter)

15 MR. STRASFELD: All right, so
16 what's the answer?

17 MR. TRONE: Well, that's the nine
18 fields that we came up with. So what I did
19 was I spent four months inside the offices
20 stress testing all these various fields and
21 thresholds, put the screwdriver down a
22 little bit tighter on the threshold, how
23 many survivors do you have, loosen it up.
24 And in a turn now, we have eight years of
25 actual experience of running this due

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1 diligence process that we can show the
2 consistency of the results, the
3 transparency, the objectivity of the whole
4 process.

5 MR. STRASFELD: Now, how would
6 this overlay on the investment advice
7 associated with an adviser using affiliated
8 funds? They would apply that process to
9 their own funds and see how it compared to
10 the various -- their peer group?

11 MR. TRONE: Exactly. There's
12 some in the industry that say the mere use
13 of a proprietary product is a fiduciary
14 breach. We would disagree. We still point
15 to the procedural prudence. Identify a
16 rules based process that you're going to
17 follow, apply to your proprietary product
18 and if your proprietary product screens as
19 well as a non-proprietary product, why not?
20 But the imprudence is to be able to
21 demonstrate that process and demonstrate
22 that it's consistently used. And the fact
23 that the process has been developed by an
24 independent objective third party, in this
25 case, the Foundation for Fiduciary Studies,

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1 it reassures the investors and the public
2 that the process is not being gamed to
3 accommodate the particular financial
4 services firm.

5 MR. STRASFELD: Thank you.

6 MR. TRONE: Thank you. Have a
7 good summer.

8 MR. STRASFELD: Thank you very
9 much. All right, last but not least,
10 Universal Retirement Consultant Group, Inc.,
11 batting cleanup.

12 MR. UNGER: Thank you. The good
13 news and the bad news. You're actual final
14 presentation. Of course, the bad news, it's
15 me. I will -- so much has been said so far
16 that I've basically thrown out my
17 presentation and I'm going to try and focus
18 on some of the inconsistencies that you may
19 believe exist based on the presentations
20 you've seen. I believe that much of those
21 differences that you've seen in the speakers
22 so far depend upon context, where they're
23 coming from. It's not my intention to cast
24 aspersions here but in large respect this is
25 about --

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1 MR. STRASFELD: You're the last
2 speaker, so --

3 MR. UNGER: Yes, well, it very
4 much is about commerce. They're all
5 representing their own best interests as
6 they should, not because it's just their
7 interest but because it's their interest,
8 that's what they believe in. But I'm
9 reminded, I guess back in March of the
10 hearing that was held on 401(k) fees. You
11 almost didn't need an announcement of who
12 the people -- who the speakers were. You
13 could kind of figure it out based on their
14 positions. I think the same was true today
15 in a large -- to a large degree.

16 And I say that only for you all
17 to take a real close look at all the
18 presentations that you've seen and put them
19 in that context, recognize where the
20 motivation people were coming from. I come
21 down firmly beside -- by the way, don't have
22 a computer model, don't represent a computer
23 model. I absolutely believe that it is
24 feasible that a computer model can be built.
25 I believe there are feasible computer models

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1 that are already built that indeed, service
2 IRA participants.

3 It's somewhat interesting that
4 some of the folks who believe that they --
5 that it cannot be done, actually encourage
6 their representatives, some strongly, in a
7 few cases actually require their
8 representatives to use their own computer
9 model to actually provide investment advice
10 to those IRA account holders and they do so
11 out of the notion or the believe that it
12 will provide them a degree of legal
13 liability relief should they end up in an
14 unfortunate arbitrary -- or arbitration
15 case.

16 So that's part and parcel to why
17 I believe it. Now, how do I get there?
18 We've said this over and over. Taking into
19 consideration the full range of investments,
20 how do we define that? It is interesting
21 that it doesn't say every investment option
22 but neither did it say a reasonable number
23 of investments. So I kind of fall in the
24 category that says that leaves a certain
25 degree of wiggle room for the Department to

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1 consider but I also recognize that it's not
2 without risks, perhaps political is the
3 right word, because with a required degree
4 of leadership and courage, not personal
5 leadership or courage but Departmental,
6 institutional leadership and courage to kind
7 of take the step that this is feasible and
8 here's how we're going to do it.

9 I actually believe the devil will
10 be in the details, and by that I mean, how
11 are we going to certify or qualify an
12 investment expert? And I've spent the
13 better part of my 28-year career, 26 years
14 of it, dedicated to the retirement industry
15 but also always involved on the investment
16 side and struggling to manage these two very
17 different disciplines in the context of
18 retirement planning. It's -- it is, I
19 recognize very, very challenging.
20 Nevertheless, I think it's done. It's done
21 regularly and it all boils down to
22 ultimately how you're going to define the
23 regulation. Your biggest concern, I think
24 will be how do you certify these things and
25 who's an expert.

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1 I've said this over and over
2 again, there's no such thing as an
3 investment expert. There's no such thing as
4 a retirement expert, only diminishing levels
5 of ignorance. And I guess if you're less
6 ignorant than the person you're talking to,
7 then you can argue that you're adding value.
8 I do want to mention how I eventually came
9 to be here. I know I was in discussions
10 with several people at the Department of
11 Labor and actually began in conversations
12 that I had with some of the staff with
13 Representative Miller and it's my
14 theorization or hypothesis that the
15 retirement market, most notably 401(k)s but
16 I believe it still applies to other
17 individual account plans, specifically IRAs,
18 are in a least a certain degree of true
19 blown market failure and I mean market
20 failure in the true industrial
21 organizational macro-economic theory of
22 market failure.

23 Not to remind you of your
24 freshman Economics 101 course, but there are
25 serious structural problems to the

1 marketplace and it is occurring specifically
2 at the participant level and I actually
3 don't care whether you're talking about an
4 IRA or a 401(k). You can have literally
5 identical investors, literally identical
6 retirement savers, who save the exact
7 amount, even invest using the exact same
8 percentages over the exact same investment
9 managers and end up with stunningly
10 different numbers come retirement; one
11 ultimately retires in safety security and
12 the other one can't retire at all.

13 How can that be? And I believe
14 there are a host of reasons, over-
15 regulation, under-regulation, poorly written
16 regulation. Yes, our industry does have its
17 share of less than scrupulous providers, but
18 I think in the end it all boils down to
19 asymmetry of information. It's a very
20 complex marketplace, very complex topic.
21 When we try to simplify it in a way to
22 explain it to those providers or
23 participants or plan sponsors, if it's an
24 employer based plan, it becomes very, very
25 difficult and the degree of ignorance,

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1 pardon my expression there, but the degree
2 of ignorance is all over the lot.

3 I could go on and on with regard
4 to that notion of what I sometimes refer to
5 as the black market of IRA accounts, the
6 black market of 401(k) accounts, but I do
7 believe to a degree it does exist. And it
8 is -- while it seems far afield from this
9 issue of, well, can I have a computer model
10 or not, will a computer model work or not, I
11 believe that in the end these computers
12 models and part of the challenge that you're
13 receiving so much differing feedback is that
14 virtually all the models are founded on
15 modern portfolio theory as originally
16 theorized by Dr. Markowitz and then others
17 later on with what's often referred to as
18 post-MPT, which defines risk slightly
19 differently and differentiates between good
20 risk and bad risk, and the finally, I
21 believe you saw financial engines in Bill
22 Sharp's group focused on adding to MPT
23 optimization, portfolio optimization, the
24 notion of Monte Carlo analysis, which is
25 really just probabilistic planning in my

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1 opinion, applied.

2 Of all of the models that I've
3 seen, the probabilistic planners are
4 probably the most useful but not for the
5 reasons you may think. They're useful
6 because they're educative to the
7 participant. Wait, if I put 100 percent of
8 my money in the most risk -- or the risk-
9 free investment, I actually take more risk?
10 And that's what those models can show, and
11 for that reason they can become I believe
12 somewhat valuable, but it's not for what
13 many IRA participants really think it is and
14 that is, "Well, if I do this, I'll make more
15 money", and I believe absolutely, that's
16 false. At least I'll make more money over
17 and above or after I pay the fees associated
18 with utilizing that particular service. And
19 I believe that that's probably false.

20 As a consequence, and this comes
21 back to my notion on market failure, I
22 really believe there are only two standards
23 and principals that ought to be applied.
24 One is diversification, the very standard
25 laid out in ERISA itself but one that I

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1 think is the single most valuable and
2 important aspect, are you properly
3 diversified, I'll expand on that in a
4 minute, and then question number two is,
5 what are the expenses, how much am I paying?

6 Now, there are a number of
7 assumptions in stating that those are the
8 two most important criteria and I don't
9 nearly have the time to go into that, but
10 I'll try to briefly explain what I mean. I
11 envision a model where you first start with
12 tiers and if we were talking about an
13 employer-based plan, a 401(k) plan, well,
14 there you have typically a set of core
15 vehicles. Will they fit tier one? Tier one
16 says there's a cash or cash equivalent.
17 There's a domestic fixed income and there's
18 a domestic equity vehicle. Does that exist
19 in the plan?

20 If it does, it's a tier one plan.
21 But what if it goes a step further, that
22 there's an international equity component?
23 Well, then it's a tier two plan, et cetera.
24 And then you continue to slice and dice
25 until you've expanded into a wide range of

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1 different asset categories. Now, a number
2 of them we throw out as was stated earlier.
3 I don't care if Malaysian Mortgage Back
4 Riser available in a foreign currency are
5 part of the option. This is an IRA account.
6 Remember who we're talking about. I really
7 don't care about the one percent of IRAs
8 that are more than \$200,000.00.

9 Guess what? They're not the
10 problem. They're not the users of a program
11 like this. It's everybody else, it's the
12 other 99 percent. And as such, I'm very
13 comfortable with the notion that the
14 Department takes a stand and says, "We don't
15 care about a lot of the alternative
16 investments or esoteric aspects, that a
17 model can still be certified without that".
18 So again, I recognize that my comments here
19 today do make certain assumptions that you
20 will have to make for them, in fact, to be
21 adopted or true even, but nevertheless,
22 that's where I'm coming from and one of the
23 reasons why I think it can absolutely work.

24 So with that, everything has been
25 repeated many, many times so I'm going to go

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1 ahead and stop. Any questions, comments?

2 MR. PIACENTINI: Well, of the
3 witnesses, I think you used the most
4 language of economics and I'm the economist
5 on the panel, so I'll ask a couple of
6 questions.

7 MR. UNGER: Oh-oh.

8 MR. PIACENTINI: You talked about
9 market failure and then gave an example
10 saying that people who were identical go to
11 the same place, save at the same rate can
12 have different outcomes. What's behind
13 that? Are they investing differently?

14 MR. UNGER: No, they'll invest
15 identically, literally the same fund, but --

16 MR. PIACENTINI: Elaborate.

17 MR. UNGER: -- one example of
18 market failure is that on one plan you were
19 able to get that money manager in their
20 institutional class of share, charges 67
21 basis points, okay, not bad. And the other
22 plan, guess what, they're getting the most
23 expensive class of share which is 200 basis
24 points.

25 MR. STRASFELD: And a six percent

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1 load.

2 MR. UNGER: And a six percent
3 load. I'm not done though. Guess what else
4 is happening? RAP feels are coming into the
5 industry. Who does it apply to? Sometimes
6 it's the TPA. What's also occurring here?
7 We've forgotten about what vehicles are
8 available. Well, now we're talking about
9 the gamesmanship that occurs in getting your
10 fund, if you're an asset manager, onto a
11 particular platform. How much money are you
12 going to pay as a sub-TA or what's called
13 revenue reduction, in any other industry, by
14 the way, called a kickback.

15 And we're still not done. We've
16 got different service standards. If you
17 look at many of the bundled providers and
18 I'm picking on 401(k) and I think they're
19 less applicable to IRAs, so I'm starting to
20 get far afield, reel me back in when you
21 want me to stop, but here you've got
22 standards where many platforms are SAS-70
23 compliant and actually meet the Gramm-Leach-
24 Bliley Act requirements for a security and
25 other platforms aren't SAS-70 and don't meet

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1 Gramm-Leach-Bliley. In fact, that
2 participant's data is not secure regardless
3 of whether they're actually posting a
4 privacy statement or not.

5 Guess which one is cheaper to
6 run? Guess which one offers greater
7 profitability?

8 MR. PIACENTINI: So all of those
9 differences is really coming down to fees
10 and expenses of one type or another.

11 MR. UNGER: And in the end, when
12 you look at any of these funds, and you can
13 go back to Professor Rubin's study out of
14 PACE, or any one of a number of other
15 studies, I would guess that they're probably
16 longer than your arm, there's a sound
17 argument to be made that passive investing,
18 passive index investing has a tendency to
19 outperform active management over extended
20 periods of time. There's no doubt that
21 active managers come into vogue and out of
22 vogue based on their philosophies and
23 perspectives on the overall economics of
24 the current economy and as a result,
25 outperform, but now I'm getting onto a

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1 slippery slope probably ticking off what I
2 would have hoped would have been a lot of my
3 potential customers, but the reality is
4 exchange traded funds are out there. It is
5 the white elephant in this room that we're
6 not talking about.

7 If you adopt this notion that,
8 yes, large cap for the S&P 500 index is
9 going to outperform upwards of 70 or 75
10 percent of any other large cap core say
11 mutual funds or any manager for that fact,
12 managing in that universe or swimming in
13 that pool of stocks, gets wet. You know,
14 you have trouble not investing in an index
15 fund.

16 Now, the problem there is
17 traditionally, your priority ETFs, you
18 couldn't get a number of -- you couldn't get
19 a small cap value index fund, mutual fund.
20 Well, now ETFs are here and you can. You
21 can't get it yet in 401(k) plans in a way
22 that answers or provides their principal
23 value which is by definition style adherence
24 which in my opinion is probably actually
25 maybe the only thing more important than

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1 fees, but you know, now that you can make
2 diversification occur in an IRA, if you
3 actually do this, use discount brokerage,
4 take a \$10,000.00 IRA, even that small, it's
5 amazing. You can go to a discount brokerage
6 house, open up your IRA with \$10,000.00,
7 trade it in ETFs at 20 bucks a shot, take
8 into account the underlying expense ratio of
9 those and then compare it to the
10 alternatives, and you've got real issues, as
11 a financial services firm and institution.

12 Now, I would argue to those --
13 and I have, to those clients, those
14 financial services institutions, "Don't run
15 away from this, embrace it. Your value add
16 is not the ability to pick on stock over the
17 other. Your value add is the ability to
18 show proper asset allocation given the risk
19 tolerances of the individual, and ultimately
20 to provide service, hand-holding, when the
21 client gets scared because we just had a
22 real shake-out, you're there to prevent them
23 from making changes that they otherwise
24 would for emotional reasons.

25 So, I've more than answered your

1 question. I apologize.

2 MR. PIACENTINI: No, that's
3 helpful.

4 MR. STRASFELD: Thank you very
5 much. As -- for the few of you who are
6 left, I indicated at the beginning that
7 we'll hold the record open for 30 days, if
8 you have anything witty that you feel you
9 want to augment your testimony already with
10 and were are we sending it, to you? Yes,
11 the information can be forwarded to Chris
12 Motta, either by e-mail or mail or however
13 you want to do it.

14 Thank you very much for making it
15 through the day.

16 (Whereupon, at 2:51 p.m. the
17 above-entitled matter concluded.)

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