DALBAR
The Measurement of Success

September 9, 2008

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

Attn: Investment Advice

E-mail to e-ORI@dol.gov

DALBAR appreciates the opportunity to comment on the proposed regulations implementing the provisions of the statutory exemption set forth in sections 408(b)(14) and 408(g) of the Employee Retirement Income Security Act, as amended (ERISA).

Background

DALBAR was first to offer 408(g) Annual Audits for level fee fiduciary advisers in February of 2007. The DALBAR audit was consistent with 408(g) and with the regulations being proposed. The DALBAR audit consists of the following steps:

- Fiduciary Adviser initiates the audit through a disclosure questionnaire that is reviewed for compliance with 408(g).
- After review and acceptance of the disclosure questionnaire DALBAR initiates a request for documents, including eligible investment advice arrangements (EIAA), disclosure documents, tools used in advice delivery, records relating to advice delivery and complete list of plans and participants receiving investment advice.
- Documents are examined upon receipt for compliance with 408(g) using the auditor's checklist and are compliance tested by contacting a sample of plans and participants.
- Results are analyzed and two documents are produced. The Audit Report and the Management Letter. (Samples are available)
- The two documents are reviewed with the fiduciary adviser after which the Audit Report is sent to all of plans with whom the fiduciary adviser has an EIAA.

Our experience with these audits leads to the comments, suggestions and clarification requests in this letter.

Clarification of 408(g)(1)(h)(2): the sale, acquisition, or holding occurs solely at the direction of the recipient of the advice;

We have the unique perspective of actually performing 408(g) audits and are able to identify an area of operational difficulty in complying with one interpretation of 408(g) requirements that limits the use of high quality advice with no discernable benefit.

Paragraph h(2) of the statutory exemption requiring "the direction of the recipient of the advice" has caused great confusion and difficulties in periodically rebalancing participant accounts after advice is rendered. h(2) has been interpreted by some to prohibit automatic rebalancing and execution of orders on behalf of participants or beneficiaries after advice is rendered.

Most advisers are willing to perform the rebalancing automatically, as a service to participants or beneficiaries. Additionally, when recommendations involve a complex set of asset allocations involving many investment options, participants and beneficiaries, while intending to execute the recommended transactions, often fail to follow through and therefore lose the benefit of the advice.

Moreover, when viewed from a participant or beneficiary perspective, the interpretation noted produces a conundrum. The participant or beneficiary may remain in a qualified default investment alternative or use a managed account without the necessity of executing individual trades but if he or she elects to use a Fiduciary Adviser it becomes necessary to enter orders for every trade.

We suggest that the final regulations provide clarification that permits participants and beneficiaries to adopt a fiduciary adviser's recommendations in writing and enabling the fiduciary adviser to make arrangements to implement adopted recommendations and rebalance accounts periodically.

Operational Difficulties of IRA Audits

Because IRAs are offered in many more ways than employer sponsored plans, there are operational considerations in performing the required annual audits. The first area of differences exist in banks that offer IRAs at branches, where a platform officer will include an IRA in a number of products and services being recommended to a customer. The second area of operational differences are in phone centers from which IRA beneficiaries receive advice about the selection and changes to IRA investments.

In the case of banks that offer IRAs, there may <u>not</u> be a separate affiliate that provides advice to IRA beneficiaries. The annual audit would therefore require an examination of a large number of records, many of which would not be relevant to the audit. Alternatively, the validity of the audit is compromised if the bank self-selects sample records to be audited. This operational difficulty can be overcome by permitting a computer record of all IRA activity to satisfy the record-keeping requirement.

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Phone centers that deliver advice to IRA beneficiaries present the challenge of obtaining an eligible investment advice arrangement and making disclosures to existing accounts. Millions of existing IRA accounts are served by phone centers, making it impractical and prohibitively expensive to meet these requirements on any one date. Waiving the EIAA requirement for existing accounts and permitting the disclosures to those accounts after the fact, with the next account statement, will overcome this difficulty.

Response to Request for Comments on:

Compensation Requirements [paragraph (c)(1)(iii)]
Inappropriately Favor Investment Options [section 408(g)(3)(B)(iv)]
Safeguards Against Conflicts of Interest
Computer Model Standards

While more precise guidance for Compensation Requirements, Inappropriately Favoring Investment Options, Safeguards Against Conflicts of Interest and Computer Model Standards can be effective; such guidance will require extensive enforcement measures to be meaningful. Without enforcement, regulations will be bypassed with impunity and violations could ultimately become the norm.

Given that the ultimate goal is to maximize the retirement benefits for participants and beneficiaries we believe that the most effective approach is to continuously measure the <u>outcome</u> for the participants and beneficiaries. In this way, variance from standards can be used to identify cases of potential non-adherence of fiduciary responsibilities for further investigation.

Annual reporting (Form 5500 for employer sponsored plans and a simplified form for IRAs) should be enhanced to include the disclosure of the investment return and total fees for each separate age cohort (20 –29, 30-39, etc.). The aggregate result from all reports (Benchmark) should be published annually. Participant and beneficiary quarterly statements should then be required to include comparisons of actual returns and expenses to the Benchmark.

This outcome-based approach provides a great incentive to act in the best interest of the participant or beneficiary.

Comments on Electronic Delivery of IRA Audit Report

The proposal for electronic delivery of audit reports is consistent with our findings that beneficiaries who have little interest are no more likely to read a mailed disclosure than to visit a Website. Conversely the beneficiaries who are interested will use the Website and most prefer the efficiency and convenience of the electronic access.

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Definition of Material Contract Relationship

The proposed definition of material contractual relationship may not account for four additional areas of potential conflicts of interest. The first is that an affiliate, department or independent contractor of a larger firm may fail the 10% test while the entire firm remains below the 10% threshold. The second is non-revenue financial arrangements. The third is non-cash considerations. The forth is reciprocal audit arrangements between advisers or their affiliates.

Our recommendations for each of these four potential auditor conflicts of interest are:

1. Affiliate, department or independent contractor of a larger firm (Subset). The potential conflict arises when the Subset has a material relationship but the firm in question does not. Our recommendation is that the material relationship test should apply to the affiliate, department or independent contractor performing the audit.

2. Non-revenue financial arrangements (Non-revenue). Non-revenue items can include purchases or leases between the fiduciary adviser and the prospective auditor. The Non-revenue items have the same effect on the auditor's compensation as revenue. An example might be that the prospective auditor leases office space from the fiduciary adviser. Our recommendation is that all Non-revenue should be added to revenue in performing the 10% test.

3. Non-cash consideration (Non-cash). Non-cash includes barter, recommendations made to third parties with respect to the fiduciary adviser, sales leads, waiver of payments, price reductions, rights, options, etc. Non-cash has the same effect on the recipient, as does revenue. Our recommendation is that all Non-cash should be valued and added to revenue and Non-revenue in performing the 10% test.

4. Reciprocal audit arrangements between advisers or their affiliates (Reciprocal Business). After meeting the 10% test, including revenue, Non-revenue or Non-cash arrangements discussed above, a material contractual relationship may still exist if one adviser is permitted to audit another. This Reciprocal Business has the potential for a "one hand washes the other" conflict that is independent of the 10% test. Our recommendation is to treat Reciprocal Business as a material contractual relationship, independent of the dollar amounts involved.

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Guidelines for Auditor Selection

While we fully agree that specific criteria by the Department to define requirements for the independent auditor, general guidelines will facilitate the process of selecting an auditor. We recommend that the Department consider issuing the following general guidelines:

- Experience: Number of years that the prospective auditor has acted as independent third party to financial advisers.
- Published Work: Papers or reports that the prospective auditor has published which relates to investment advice and ERISA.
- Skill Set: Capabilities to perform tests required by a 408(b) audit, including developing standards and benchmarks, evaluating understandability, conducting surveys, familiarity with business practices and documents and technology used by advisers.
- Applicable Knowledge Base: The prospective auditor's knowledge of the regulations that apply to the fiduciary adviser, including ERISA, IRC 4975, Securities Act of 1933, Securities and Exchange Act of 1934, Investment Company Act of 1940, Investment Adviser Act of 1940, and applicable regulations from the Department, IRS, SEC, FINRA, banking and insurance regulators.

Thank you for your consideration of these comments in developing the final regulations.

Louis S. Harvey
President

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