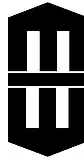

MONEY MANAGEMENT INSTITUTE

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August 28, 2013

Ms. Laura A. Henry
Analyst
U.S. Government Accountability Office
701 5th Avenue
Suite 2700
Seattle, WA 98104

Re: GAO Study of Managed Account Arrangements in 401(k) Plans

Dear Ms. Henry:

The Money Management Institute ("MMI") appreciates the opportunity to submit these responses to questions posed by the Government Accountability Office ("GAO") in connection with the GAO's study of managed account arrangements in 401(k) plans.

MMI is a national organization for the advisory solutions industry, representing portfolio manager firms and sponsors of investment consulting programs. MMI was organized in 1997 to serve as a forum for the industry's leaders to address common concerns, discuss industry issues and work together to better serve investors. Our membership comprises firms that offer comprehensive financial consulting services to individual investors, foundations, retirement plans and trusts; related professional portfolio management firms; and firms that provide long-term services to sponsor, manager and vendor firms. MMI is a leader for the advisory solutions industry on regulatory and legislative issues.

As a representative of the advisory solutions industry, MMI appreciates the opportunity to comment on the GAO's questions on managed account arrangements in 401(k) plans. Our members include managed account providers, many of whom have been active in developing managed account arrangements for use in 401(k) plans. MMI believes that managed account arrangements present value to 401(k) plan sponsors and participants because they provide participants with flexibility to choose to have their 401(k) plan assets professionally managed, instead of managing their assets on their own. When used appropriately, we believe managed account arrangements benefit participants by giving them access to investment expertise that can improve investment outcomes, thereby increasing the probability that participants will reach their retirement income or savings goals. Managed account arrangements are also beneficial because they decrease the amount of time participants need to devote to managing their retirement savings, and thus can improve participant satisfaction with 401(k) plans. MMI would support efforts to educate plan sponsors and participants about how managed accounts work, how they are regulated, and their potential costs and benefits.

I. Background

401(k) plan managed accounts are a relatively new feature in our retirement system. Before addressing the specific questions the GAO has posed, we believe it would be helpful to provide some context on how our retirement system has changed and why these changes have made managed accounts an increasingly attractive option for 401(k) plan sponsors and participants.

Assets held in defined contribution retirement plans, including 401(k) plans, have increased significantly over the past decade and now account for the largest and fastest-growing component of the employer-sponsored retirement system. According to a recent quarterly retirement market update issued by the Investment Company Institute, defined contribution plans held $5.4 trillion in assets at the end of the first quarter of 2013, compared to $2.7 trillion held by traditional defined benefit pension plans.[1] While defined benefit plan assets grew by 35% from 2000 through the first quarter of 2013, defined contribution plan assets grew over twice as fast—by 86% over the same period. As employers continue to freeze and terminate private sector pension plans and shift benefits to defined contribution plans, many predict that this trend will continue.[2]

The movement from defined benefit to defined contribution plans has changed the way retirement investments are managed by shifting investment decisions and risk away from the plan sponsor to the participants. In a typical defined benefit pension plan, investment decisions are made by investment fiduciaries, who are typically a plan sponsor-designated investment committee. In many cases, the investment committee receives help from professional investment consultants and asset managers in selecting investments and allocating among asset classes. In contrast, in a typical 401(k) plan (a popular type of defined contribution plan), the plan fiduciaries designate a menu of investment options for the plan, such as mutual funds, bank collective investment trusts, insurance company separate accounts and other types of commingled investment funds, and then participants direct the investment of their individual accounts by allocating their assets among these designated options.

Although, recognizing that participants need access to professional advisory services, many plans offer assistance to participants in the form of investment education, nondiscretionary investment advice, and discretionary investment management, many participants are left to make investment decisions on their own. Thus, the growth of defined contribution plans has tended to remove retirement assets from structures where assets are managed by experts to structures where investment decisions are made by individual participants, who often lack the expertise and time needed to make informed investment decisions.

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[1] Investment Company Institute, *Retirement Assets Total $20.8 Trillion in First Quarter 2013*, June 26, 2013, *available at* www.ici.org/research/stats/retirement/ci.ret_13_q1.print.

[2] *See, e.g.*, U.S. Social Security Administration Office of Retirement and Disability Policy, *The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers*, Social Security Bulletin, Vol. 69 No. 3, 2009.

The potential impact of leaving investment decisions to 401(k) plan participants with little or no investment expertise has concerned regulators, employee advocates, plan sponsors, and investment professionals alike. These potential effects have been the focus of studies comparing investment performance in defined benefit plans to performance in participant-directed plans. For example, one study indicates that defined benefit plans have consistently outperformed defined contribution plans by approximately 1% on average in terms of medians weighted by plan assets.[3] A 1% difference in performance over a participant's working life can have a dramatic impact on the amount the participant is able to save for retirement.[4] It is also worth noting that defined benefit plans outperformed defined contribution plans by margins of greater than 2% during the two most recent bear markets in 2000-2003 and 2008.[5]

Studies have also focused on identifying potential reasons for the underperformance of defined contribution plans relative to defined benefit plans. Some studies suggest 401(k) plans perform poorly because participants tend to manage their investments by transferring assets to funds that have a recent history of high performance.[6] These studies indicate that "chasing returns" tends to result in lower returns because high performance is generally temporary, and fund performance tends to regress to the mean.[7] Other studies indicate that the plethora of investment options offered on a typical 401(k) plan menu impedes participant decision-making.[8] "Option overload" may result in asset allocations that may not be best suited to achieving the participant's retirement goals, for example, where the participant's account is invested by default or the participant allocates assets equally to each available option.[9] These studies also suggest that the more investment options there are, the less likely employees are to participate in the plan.[10] Others have suggested that participants are overwhelmed by the large amounts of information and disclosures they receive about their 401(k) plan investments and cannot easily find and absorb the information they need to make informed investment decisions.[11] These, among other potential causes of underperformance in 401(k) plans,

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[3] Towers Watson, *Defined Benefit vs. 401(k) Investment Returns: The 2008-2009 Update*, March 2011.

[4] The Department of Labor illustrated the effect of a 1% decrease in investment returns in an example demonstrating the impact of 401(k) plan fees. In the example, an employee with 35 years until retirement had a 401(k) account balance of $25,000. If the participant's returns on investments net of fees over 35 years averaged 6.5%, the participant would have $227,000 at retirement. But, if the participant's returns net of fees over the same period averaged 5.5%, his account balance would grow to only $163,000. The 1% difference in returns would reduce the account balance at retirement by 28%. U.S. Department of Labor, Employee Benefits Security Administration, "A Look at 401(k) Plan Fees," Oct. 2010.

[5] Towers Watson, "Defined Benefit vs. 401(k) Investment Returns: The 2008-2009 Update," March 2011.

[6] *See, e.g.*, E. J. Elton, M. J. Gruber, & C. R. Blake, "Participant Reaction and the Performance of Funds Offered by 401k Plans," Journal of Financial Intermediation (2007).

[7] *Id.*

[8] *See, e.g.*, G. Huberman and W. Jiang, "Offering versus Choice in 401(k) Plans: Equity Exposure and Number of Funds," Journal of Finance 61(2) (2006); Z. Bodie & H. Prast, "Rational Pensions for Irrational People: Behavioral Science Lessons for the Netherlands," Netspar Discussion Papers (2011).

[9] *Id.*

[10] *Id.*

[11] *See, e.g.*, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43014, 43016 (proposed July 23, 2008) (noting that "information that is too detailed may overwhelm participants."); The ERISA Industry Committee, Letter to Office of Regulations and Interpretations, Employee Benefits Security Administration re: Fee Disclosure RFI (July 19, 2007); L. Boselovic, "New

suggest that participants may benefit from the help of an investment professional in managing their 401(k) plan accounts.

In part in recognition of these issues, more participants are investing their 401(k) plan accounts in options that are managed by investment professionals. These options include both customized managed accounts, as well as investment funds, such as target date funds ("TDFs"), in which asset allocations (while not customized to individual investors), are designed for groups of participants who are of a particular age or have the same time to retirement. One study predicts that 55% of all participants will be invested in these types of investments by 2017.[12] This study indicates that approximately 3% of all participants used a managed account arrangement in 2012 and predicts that this percentage will grow to approximately 4% by 2017.[13] Thus, although managed accounts are a relatively small component of the U.S. retirement system, they are growing in popularity and offer participants, who wish to have their accounts professionally managed, access to customized investment expertise.

The U.S. Department of Labor ("DOL"), the federal regulator charged with responsibility over the fiduciary rules that apply to 401(k) plans under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), has recognized that it is important for participants to have access to investment experts and advice in making decisions about how to allocate their 401(k) plan accounts. In connection with releasing a regulation governing investment advice services for plan participants, the DOL stated, "given the rise in participation in 401(k) type plans . . . the retirement security of millions of America's workers increasingly depends on their investment decisions. Thus, there is increased recognition of the importance of quality investment advice in helping participants avoid costly investment errors."[14]

Moreover, in promulgating rules regarding fiduciary liability in participant-directed plans, the DOL recognized managed account arrangements as a way for participants to gain access to expert investment assistance. Specifically, in issuing its regulation regarding "qualified default investment alternatives" ("QDIAs"), which provides plan fiduciaries relief from fiduciary liability for participants' accounts that fail to affirmatively self-direct their plan accounts, the DOL included managed accounts as one of the QDIA categories that are appropriate for the long-term investment of participant accounts.

Regulations to Make 401(k) Quarterly Statements Even Longer," Pittsburgh Post-Gazette, (Aug. 30, 2012).

[12] Vanguard Institutional Investor Group, *How America Saves 2013: A Report on Vanguard 2012 Defined Contribution Plan Data*, June 2013.
[13] *Id.*
[14] U.S. Department of Labor, "Fact Sheet: Final Rule to Increase Workers' Access to High Quality Investment Advice," Oct. 2011.

II. How managed account arrangements in 401(k) plans are structured

Managed account arrangements directed at the 401(k) plan market can be structured in numerous ways and include various features that differ across plan recordkeepers, administrators and managed account providers. At its most fundamental level, a managed account is an investment management service made available to plan participants through their plan under which an investment professional manages, pursuant to stated models or guidelines, the asset allocation or investments of a participant's account (or portion thereof).[15]

Within this basic construct, managed accounts may include a variety of features:

- ***Participant Access to Managed Account Arrangements:*** Participants may affirmatively opt into a managed account arrangement that the plan's fiduciaries have selected and made available under the plan. When participants affirmatively choose the managed account option, they may then execute documents with the manager, which typically include an investor questionnaire and risk tolerance survey. Based on their answers to the questionnaire and survey, the manager will create an individualized investment policy statement or guidelines for their accounts and manage the accounts accordingly.

  Participant accounts may also be invested in a managed account arrangement by default. Under DOL rules, plan fiduciaries may designate a managed account as the plan's QDIA. As such, unless the participant expressly directs otherwise, the participant's account is automatically enrolled in the managed account option. In such instances, the manager may adopt the account's investment policy or guidelines based on information provided by the plan fiduciary through the plan's recordkeeper or administrator, which may include only the participant's age and target retirement date, or may include other information obtained by the recordkeeper.

- ***Participant Demographics and Characteristics Considered:*** The types and amount of information collected about participants and the ways this information is used to choose investments and develop an asset allocation strategy vary significantly. For example, in one managed account arrangement, the investment manager establishes the account's investment policy or guidelines solely based on the participant's birth date and anticipated

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[15] Participants may also hire an investment manager outside of the plan to manage their plan assets (e.g., through an open brokerage window, or where a participant gives an investment manager login information needed to access and manage account investments through the plan's website), in which case the plan fiduciaries and sponsor may not be aware of the arrangement. We believe these arrangements may be beyond the scope of the GAO's study and have not addressed them here, but will provide additional comments if of interest.

retirement date, which may change over time as the participant approaches her retirement date.

In other arrangements, the investment managers may take into account other information, such as salary and monthly contribution amounts, or may use investor questionnaires to gather additional information, such as the participant's risk tolerance, retirement savings and income goals, marital status and savings held outside of the plan. These types of programs can result in a more customized asset allocation that is tailored to the individual investor's circumstances and can change over time as the investor's circumstances, goals and preferences change.

- ***Investments Available Through the Managed Account Arrangement:*** Investments used within a managed account arrangement may be limited to just those options available on the plan's menu (i.e., the mutual funds and other collective investment funds chosen by the plan fiduciary), in which case the manager would implement an asset allocation strategy based on the funds and asset classes available through the plan.[16] For example, to implement a large-cap growth stock allocation, the manager would invest the participant's account in the large-cap growth stock investment option available from the plan's investment menu. Thus, the manager's activities may be limited to asset allocation as the menu of available funds will remain with the plan fiduciary.

  Alternatively, the investment manager may be able to select investments, such as mutual funds, ETFs, stocks, bonds, commodities, and REITs, that are not otherwise available from the plan's investment menu. So-called open-architecture structures may use investment options available through a plan's open brokerage window, or may include a broader array of investments available to the manager independently from the plan. In these arrangements, the manager is responsible for both asset allocation and investment choice. Moreover, these types of arrangements may facilitate access to more sophisticated types of investment strategies and products (e.g., real estate and commodities, as the manager is not limited to the plan's investment menu).

- ***Investment Goals:*** Managed account arrangements are designed to achieve various investment goals. For example, some managed accounts are designed to balance potential risks and returns in a manner that takes into account the participant's time to retirement. These types of managed account arrangements may also take into account a participant's risk tolerance and allocate assets more or less conservatively, as appropriate. Other managed

[16] Managed account arrangements that use the plan's designated investment options may require that the plan make options within specified asset classes available.

account arrangements are designed to achieve a particular retirement income goal and may become more conservative as that goal is achieved.

The diversity of features and structures found in managed accounts gives managed account providers and plan sponsors great flexibility to design and select a managed account arrangement that is appropriate for a particular plan and its participants. The adaptability of managed accounts is one of the advantages they offer to participants, sponsors, and service providers that we discuss in the next section.

III. What the advantages and disadvantages of managed accounts are for 401(k) plan participants, sponsors, and managed account service providers

Managed accounts offer many advantages to participants, sponsors, and managed account service providers. Although they may not be suited for all plans and participants, we believe that they offer value to 401(k) plan sponsors and participants because they provide ready access to professional management and investment expertise within the 401(k) plan structure.

Participants

We highlight three primary benefits participants receive from investing through a 401(k) plan managed account arrangement. First, participants are provided access to professional asset management services. This may result in more disciplined asset class diversification, both at the outset and over time; a more systematic approach to account rebalancing; and, where applicable, broader access to asset classes and actual account investment options. Furthermore, professional management may result in a participant's account being more appropriately managed to achieve the participant's retirement goals, particularly in light of the studies suggesting that participants tend to employ ineffective strategies (e.g., chasing returns). One study showed that 401(k) plan assets under professional management (in both TDFs and managed accounts) experienced significantly higher returns than 401(k) plan assets managed by participants.[17] Another study indicates that professional management curtails investment risk by decreasing the dispersion of total return outcomes.[18] This study indicates that 5th- and 95th-percentile five-year total returns for managed accounts were 0.2% and 3.6%, respectively, while the same returns for participants whose accounts were not professionally managed were -1.9% and 6.4%.[19]

Second, managed accounts reduce the amount of time participants need to devote to managing their plan investments. Instead of taking the time to evaluate various investment options and asset allocations, and periodically rebalancing their accounts, participants in managed accounts generally outsource these responsibilities to a

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[17] Financial Engines & AON Hewitt, *Help in Defined Contribution Plans: 2006 through 2010*, Sept. 2011.

[18] Vanguard Institutional Investor Group, *How America Saves 2013: A Report on Vanguard 2012 Defined Contribution Plan Data*, June 2013.

[19] *Id.* Although the dispersion of outcomes for managed accounts was greater than that for target date and balanced funds, this study indicated that the greater dispersion was the result of the customized nature of managed accounts and further predicted that dispersion would decrease as managed account arrangements become more prevalent.

professional manager. This not only saves participants time, but may also mitigate the adverse effects of information and choice overload on investment decision-making and plan participation noted above.

Finally, managed account arrangements offer an alternative to TDFs as a means to provide participants with professional investment management services. TDFs are commingled investment vehicles (*e.g.*, a mutual fund) managed based on a "target" retirement date. These funds automatically adjust their asset allocations to become more conservative over time, and employ the same asset allocation and glide path for all investors in the fund. In contrast, a managed account can be customized to the needs of a particular participant and can take into account the participant's risk tolerance, savings and income goals, assets held outside the 401(k) plan, and other information. This enables the manager to develop asset allocations and select investments that are suitable to an individual participant's retirement goals and risk tolerance. Managed accounts may also provide greater flexibility as the account's strategy can be adjusted to meet changes to individual participants' circumstances and changing economic conditions. In fact, for many plans, offering TDFs alongside a managed account as part of the plan's investment lineup may provide participants with a useful array of choices for allocating their assets. Those participants who desire simplicity can select the target date option, while those seeking additional personalization can select the managed account.

Of course, in spite of these and other advantages, managed accounts may not be appropriate or desirable for all plans and participants. But, we note that managed accounts are investment *options* and not required to be offered to participants. It is up to plan fiduciaries and participants to determine whether a managed account arrangement would be beneficial to the plan and to the individual participant. So long as they have adequate information and disclosures, participants should have the option to decide whether participating in a managed account is best for them.

Plan Sponsors

Plan sponsors benefit from managed accounts because they are an efficient means to provide plan participants with access to professional investment management without materially increasing the plan sponsor's fiduciary liability exposure. An ongoing concern among plan sponsors has been how to provide participants with access to tools, such as professional investment management and advice services, without incurring liability for the decisions of and advice and education provided by such tools. Under DOL rules, managed accounts are one way to provide participants with access to professional assistance without expanding the plan sponsor's liability.

ERISA, which generally applies to 401(k) plans, requires that plan fiduciaries, including the plan's investment committee that has discretion over a plan's investments, act with the care, skill, prudence and diligence of a prudent person, and solely in the interest of the plan's participants.[20] This is commonly referred to as the "prudent expert" standard of care. ERISA imposes liability on fiduciaries who fail to act in a manner that is consistent with this standard of care. But, when an investment manager is properly

[20] ERISA § 404(a).

appointed, as discussed in more detail below, the plan's investment committee will not be liable for the investment manager's decisions with regard to the managed account.[21] Rather, the fiduciaries remain liable only for prudently selecting and monitoring the investment manager, which is similar to the responsibility that the fiduciary retains with respect to the other investment options made available under the plan's menu. The investment manager becomes an ERISA fiduciary with respect to the investment of the assets in the managed account, and assumes the related liability. Managed accounts are thus a way to deliver professional investment management services to participants while minimizing fiduciary liability risks for plan sponsors. This may encourage plan sponsors to offer participants access to professional management within 401(k) plans.

Anecdotal evidence suggests that participants increase participation and contributions, as well as investment returns, when managed accounts and other investment assistance are available through the plan.[22] This increases retirement savings and, thus, is likely to improve employee satisfaction with the employer's retirement benefits and the ultimate adequacy of retirement savings to meet retirement needs—a further benefit to plan sponsors.

Managed Account Providers

In addition to benefiting participants and plan sponsors, managed accounts benefit their providers by giving them the ability to differentiate themselves from their competitors. As noted above, when an investment manager offers a managed account, it becomes an ERISA fiduciary with respect to the assets invested in the managed account. The flexibility to offer fiduciary investment services, as well as the ability to customize managed accounts for particular plans and participants, enables investment managers to diversify their product offerings and may result in increased appeal to retirement plan customers.

The advantages of being able to offer fiduciary investment services come with the risks of increased fiduciary liability. As discussed in more detail below, managed account providers must adhere to ERISA's stringent fiduciary standards and prohibited transaction rules. Failure to comply with ERISA can result in lost income, excise taxes, and other expenses.

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[21] ERISA § 405(d).

[22] Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans, "Report of the Working Group on Optional Professional Management in Defined Contribution Plans," Nov. 7, 2003.

IV. How 401(k) plan sponsors understand and negotiate managed accounts, including service provider compensation and fees

In selecting a managed account arrangement, plan fiduciaries are subject to the same ERISA prudent expert standard they are subject to when selecting other service providers to the plan. The DOL has said that fiduciaries should engage in "an objective process that is designed to elicit the information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service."[23] Plan fiduciaries may comply with this standard in a variety of ways, for example, by conducting a due diligence process with internal personnel or with the assistance of an investment consultant. Fiduciaries may also conduct an RFP to compare vendors and obtain the most suitable arrangements for the plan and participants. Fiduciaries would need to consider whether the managed account provider has the objective qualifications to properly provide the service to the plan by reviewing information about the manager's expertise, training, education, performance record, technical capabilities, financial condition, regulatory enforcement actions, litigation history, and other relevant factors.[24]

In addition to considering qualifications, plan fiduciaries would also need to evaluate whether the managed account provider's fees are reasonable in light of the services and compared to other managed account providers in the market. This may be accomplished through RFPs, with the assistance of investment consultants, and by other methods. As discussed below, recently finalized DOL regulations under ERISA section 408(b)(2) require service providers, including managed account providers, to disclose comprehensive information about services provided and the compensation service providers receive, both directly from the plan and from third parties, in connection with the services provided to the plan. Plan fiduciaries should use these disclosures as the basis for evaluating the reasonableness of a managed account provider's fees and other compensation. Plan fiduciaries can also find information in the manager's Form ADV (if the manager is a federally registered investment adviser), the investment management agreement, and other materials provided in connection with the offering.

Typically, fees for managed account services are calculated as a percentage of assets under management, the level of which depends on the total assets in the plan and investment styles employed. Managed account arrangements may be offered directly to a 401(k) plan as a stand-alone service, or in conjunction with a recordkeeping platform. Where a managed account arrangement is priced as a bundled arrangement, the fees may be affected by other services and investment options that are included in the bundle,

[23] Field Assistance Bulletin 2007-01 (Feb. 2, 2007).

[24] In 1996, the DOL's ERISA Advisory Council formed a working group to prepare guidance on the selection and monitoring of service providers to ERISA plans. The list of issues and questions the working group developed is generally viewed as a good basis for due diligence on service providers. Field Assistance Bulletin 2007-01 further provides that, among other things, in the context of selecting an investment adviser, this would include consideration of the adviser's experience and qualifications, as well as the extent to which the advice to be furnished will be based on generally accepted investment theories.

particularly where investment options generate revenue sharing and other compensation that may offset other fees.

The fee may be charged against participant accounts that invest through the managed account, or, in some cases, may be paid by the plan sponsor from corporate assets. It is important to note that, because fees are negotiated based on total plan assets rather than on individual accounts, managed account providers are often able to offer 401(k) plan participants services at lower fee rates than they are able to offer to retail clients.[25]

V. How federal regulators oversee managed accounts in 401(k) plans and what information is required to be disclosed to sponsors and participants

Managed accounts in 401(k) plans are subject to regulation under various federal statutes. The DOL regulates and enforces the requirements that apply to managed accounts and their providers under ERISA, including the prudent-expert standard of care, the prohibitions against conflicts of interest and self-dealing, and certain disclosure requirements. Managed account providers that are federally registered investment advisers are also subject to the SEC's disclosure rules, reporting requirements, and standards of conduct as provided under the Investment Advisers Act of 1940 (the "Advisers Act"). Nationally chartered banks offering managed accounts are subject to regulation by the federal Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). Each of these regulatory regimes is discussed below.[26]

DOL Regulation of Managed Accounts in 401(k) Plans Under ERISA

401(k) plans, as employer-sponsored retirement plans, are generally subject to the fiduciary responsibility rules under Part 4 of Title I of ERISA. These rules place responsibility for plan investments solely on the plan fiduciaries, with certain exceptions.[27] But, where an investment manager is properly appointed with respect to all or a portion of the assets of the plan, the appointing fiduciary "is not responsible for the day-to-day management of such assets by the other investment managers, but must be

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[25] As an alternative, where the service is not offered as part of the plan's investment menu, participants may be able to access managed account products through an open brokerage window where available; however, the plan fiduciary may need to address certain issues with respect to account custody. In these arrangements, the negotiation of the investment management relationship would generally be directly between the participant and the managed account provider, rather than between the plan fiduciaries and the managed account provider. We believe these arrangements may be beyond the scope of the GAO's study, but will provide additional information if of interest.

[26] Managed account arrangements in 401(k) plans are most commonly managed by investment advisers registered under the Advisers Act and nationally chartered banks. State banks, advisers registered solely under state law, and insurance companies may also offer managed accounts to 401(k) plans. In these cases, the managed account would be subject to applicable state banking laws, state investment advisers laws, or state or federal insurance laws, as the case may be. Furthermore, some managed account arrangements may be offered in 401(k) plans that are not subject to ERISA, such as 401(k) plans that are established solely for a business owner and his or her spouse.

[27] ERISA § 403(a).

prudent in appointing such managers and in continuing to retain them as investment managers."[28] To be properly appointed, the investment manager must acknowledge that it will be a fiduciary to the plan and be either a registered investment adviser under the Advisers Act or state law, a bank, or an insurance company.

The delegation of fiduciary duties and liabilities to the appointed investment manager has several significant implications. First, an ERISA fiduciary is subject to standards of conduct in carrying out its responsibilities to the plan. These standards, found in section 404(a)(1) of ERISA, require that a fiduciary:

1. Act for the exclusive purpose of providing benefits to plan participants and their beneficiaries and defraying reasonable expenses of administering the plan—a duty of loyalty;

2. Act in accordance with the prudent expert standard of care;

3. Diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is "clearly prudent" not to do so; and

4. Act in accordance with the plan's governing documents (interpreted to include investment policies), insofar as such documents are consistent with ERISA.

These basic standards of conduct are supplemented by prohibited transaction rules under ERISA section 406. Those rules prohibit a fiduciary from causing the plan to engage in certain types of transactions with persons who have specified relationships to the plan, known as "parties in interest." In addition, they prohibit a fiduciary from engaging in self-dealing and other conflicts of interest using plan assets. Thus, fiduciaries cannot use their discretionary authority with respect to the plan to increase their compensation or to receive other benefits. Because of the broad scope of the prohibitions, ERISA provides several exemptions and an exemption process administered by DOL. The exemptions are specific to particular types of transactions or parties, and are generally subject to a number of conditions that limit their availability.[29]

A fiduciary who breaches the standards of conduct or prohibited transaction rules (absent an exemption) is personally liable to make good to the plan any resulting losses, and to restore to the plan any profits the fiduciary made through the use of plan assets. In

[28] Advisory Opinion 77-69/70A (Aug. 3, 1977).

[29] Prohibited transaction exemptions and other guidance commonly relied upon in connection with transactions in managed accounts include: PTE 77-4 (permitting investments in affiliated mutual funds so long as the adviser does not receive advisory fees at both the plan level and the fund level and other conditions are satisfied); Advisory Opinions 97-15A and 2005-10A (known as the "Frost Bank Letter" and "Country Trust Letter", respectively, permitting investment managers to direct the investment of client assets in affiliated and unaffiliated funds that pay the manager additional compensation, so long as the manager offsets its plan level fees by the compensation it received from the funds); Advisory Opinion 2001-09A (known as the "Sun America Letter", permitting discretionary management where model asset allocations are developed by a computer program overseen by a financial expert who is not affiliated with the adviser).

addition, courts have the authority to impose other equitable or remedial relief, such as barring the breaching fiduciary from any future role as a fiduciary to ERISA plans. If the DOL is involved in a lawsuit or settlement, it can impose a civil penalty on the breaching fiduciary of up to 20% of the amount recovered for the plan. Where the breach includes a non-exempt prohibited transaction, an excise tax is imposed on the party dealing with the plan (which may or may not be the fiduciary) of 15% of the amount involved per year until the transaction is corrected, and an additional 100% of the amount involved if the transaction is not corrected.

Where an investment manager has been appointed, the appointing party has a fiduciary obligation to monitor the performance of the investment manager, and to take steps to terminate the manager if the manager's performance does not meet appropriate standards. The appointing party further has a responsibility to periodically review the manager's fees to determine that they continue to be reasonable, and, if not, to renegotiate them (subject to the terms of the investment management agreement). Thus, while appointing an investment manager relieves plan fiduciaries of liability for the manager's decisions with respect to the managed account, the plan fiduciary is still responsible for overseeing and monitoring the investment manager—an added protection to participants.

One other point to note is that the protections from fiduciary liability for participant investment decisions afforded under ERISA section 404(c) for participant-directed plans should not be affected by offering a managed account in a 401(k) plan. Fiduciaries to participant-directed 401(k) plans commonly seek to satisfy the requirements of ERISA section 404(c), and the regulations promulgated thereunder, so that they may be shielded from liability as a fiduciary or co-fiduciary for losses resulting from participant-directed investments from among the investment options made available under the plan. The ERISA section 404(c) regulations clarify that where a participant selects a managed account program offered under the plan, the plan fiduciaries will retain ERISA section 404(c) protection and will not be liable as a fiduciaries or co-fiduciaries for the participant's decision to select the managed account.[30] In fact, the QDIA safe harbor that preserves ERISA section 404(c) protection in cases where a participant fails to direct his investments and is invested in the plan's default fund, includes managed accounts among the categories of investments that can satisfy the QDIA requirements.

In addition to the fiduciary standards and prohibited transaction rules discussed above, the DOL also imposes comprehensive disclosure requirements on managed accounts. The DOL's disclosure rules encompass three parts:

1. ***Form 5500 Schedule C:*** Requires annual reporting by plan administrators to the DOL and Internal Revenue Service of direct and indirect compensation the managed account provider received in connection with services provided to each plan client.

2. ***ERISA § 408(b)(2):*** Requires managed account providers to disclose to responsible plan fiduciaries detailed information about services provided

[30] DOL Reg. § 2550.404c-1(f)(8) & (9).

and compensation expected to be received directly from the plan and from third parties in connection with services provided to the plan prior to entering into an arrangement for services and upon any change to an arrangement.

3. ***Regulation § 404a-5:*** Requires initial, quarterly, and annual disclosures to plan participants of information about plan investments, features, expenses and performance relative to benchmarks.

These disclosure rules are intended to ensure that both plan participants and fiduciaries have sufficient information to select and monitor investment options and service providers, including managed account arrangements.[31]

SEC Regulation Under the Advisers Act

In addition to being subject to the DOL's rules, managed accounts offered by federally registered investment advisers are subject to regulation by the SEC under the Advisers Act. The SEC rules require that, among other things, advisers meet disclosure and filing obligations, comply with the antifraud provisions, and act consistently with the fiduciary standards under the Advisers Act. These rules are in addition to the requirements under ERISA.

Among the SEC disclosure and filing rules governing advisers to managed accounts is the requirement that advisers file a Form ADV. The Form ADV disclosures include: (1) the ownership of the adviser (by percentage range, not by exact amount of ownership interest); (2) the disciplinary history of the adviser, certain affiliates of the adviser, and the adviser's officers, directors and employees; and (3) the adviser's business management and trading practices, including any conflicts of interest. Form ADV is filed electronically through the Investment Adviser Registration Depository and these forms

[31] We note that both the DOL and the SEC have issued proposed rules that would require additional disclosures for TDFs, which have some similarities to managed accounts. The DOL proposal would require that participants receive a narrative and graphical explanation of how the TDF's asset allocation will change over time and the point in time when it will reach its most conservative position, and an explanation of the significance of the particular date the TDF references. Similarly, the SEC proposed rule would require a graphical illustration of the TDF's asset allocation and an explanation of when the allocation stops changing. Additionally, the SEC proposal would require that investors receive a statement informing them to consider their risk tolerance, personal circumstances, and complete financial situation; that an investment in the fund is not guaranteed and that it is possible to lose money; and the extent to which allocations among types of investments can be changed without a shareholder vote.

Although we recognize that some managed account arrangements employ an asset allocation strategy that is similar to the strategies employed by target date funds, particularly in the context of a managed account that is used as a QDIA, the variety of managed account structures does not make them amenable to a one-size-fits-all approach to disclosures. MMI believes that the DOL's and SEC's current disclosure requirements are adequate to provide participants and plan sponsors with the information needed to evaluate whether to participate in a managed account arrangement. To the extent the GAO has concerns about the sufficiency of current managed account arrangement disclosures, MMI would welcome the opportunity to provide any additional information that would be helpful to address those concerns.

are publicly available on the Internet. Part 2A of Form ADV is given to clients and describes the educational experience, business background, disciplinary history (if any), other business activities, additional compensation, and supervision of the advisory personnel on whom clients rely for investment advice.

Through enforcement of the antifraud provision in section 206 of the Advisers Act, the SEC ensures that managed account advisers do not engage in fraudulent, deceptive or manipulative conduct. Sections 206(1) and 206(2) of the Advisers Act require an adviser to make full and adequate disclosure to clients on matters that may affect the adviser's independence and judgment. Section 206 is intended to bring conflicts of interest to the attention of clients to permit fully informed decisions regarding the adviser. This stands in contrast to ERISA's prohibited transaction rules, which, unless an exemption applies, flatly prohibit fiduciaries from engaging in transactions involving conflicts, regardless of whether the conflicts are disclosed.

In addition to the specific prohibitions in Section 206, the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* held that Section 206 imposes a fiduciary duty on advisers by operation of law. The purpose of this duty is to eliminate conflicts of interest and to prevent an adviser from overreaching or taking unfair advantage of a client's trust. As a fiduciary, an adviser owes its clients more than honesty and good faith alone. Rather, an adviser has an affirmative duty of "utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts, particularly where the adviser's interests may conflict with the client's. Pursuant to this duty, an adviser must at all times act in its clients' best interests, and its conduct will be measured against a higher standard of conduct than that used for mere commercial transactions." Among the specific obligations that the SEC has indicated flow from an adviser's fiduciary duty are:

- A duty to have a reasonable, independent basis for its investment advice;
- A duty to obtain best execution for clients' securities transactions when the adviser has brokerage discretion;
- A duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances;
- A duty to refrain from effecting personal securities transactions inconsistent with client interests; and
- A duty to be loyal to clients.

Federal Bank Regulation

Banks are generally exempt from regulation under the Advisers Act and, if they are nationally chartered, are generally subject to regulation by the OCC and the FDIC.[32] The OCC charters, regulates and supervises national banks, including any investment management services they provide. OCC regulations generally refer to applicable fiduciary law in determining the duties of banks when they act as fiduciary advisers to clients, such as in a 401(k) plan managed account arrangement. In the case of a 401(k) plan managed account, the OCC requires that banks comply with the fiduciary standards of ERISA discussed above, and will refer potential ERISA violations to the DOL.[33] The FDIC also has authority to examine banks for compliance with applicable law and has established extensive examination guidelines related to banks' fiduciary duties. Similarly to the OCC, the FDIC's Examination Manual refers to ERISA for the fiduciary standards that apply when a bank provides fiduciary investment management services to an employee benefit plan, such as in a 401(k) plan managed account.[34] Like the OCC, the FDIC will refer possible ERISA violations to the DOL for review.

* * *

Thank you for giving MMI the opportunity to comment on the foregoing. If you have any questions regarding this letter, please contact me at (202) 822-4949 or cdavis@mminst.org.

Sincerely,

Christopher L. Davis
President
Money Management Institute

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[32] The National Banking Act, 12 U.S.C. § 92a; Federal Deposit Insurance Act, 12 U.S.C. § 1818. Section 202(a)(11)(A) of the Advisers Act provides an exclusion from the definition of investment adviser for banks and bank holding companies, unless they serve as investment adviser to an investment company. The OCC and FDIC are responsible for regulating nationally chartered banks while the FDIC, the Federal Reserve and state banking authorities regulate state-chartered banks. The Federal Reserve generally refers to OCC and FDIC guidance for the fiduciary standards applicable to state banks offering investment management services, and will also refer potential ERISA violations to the DOL.

[33] *See* Comptroller of the Currency, Comptroller's Handbook: Investment Management Services (Aug. 2001).

[34] FDIC, Trust Examination Manual, § 3.A.