The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 11731

March 17, 2000

INSTITUTE SUBMITS TESTIMONY TO HOUSE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS' HEARING ON ERISA REFORM

[11731] March 17, 2000 TO: PENSION COMMITTEE No. 19-00 PENSION OPERATIONS ADVISORY COMMITTEE No. 18-00 RE: INSTITUTE SUBMITS TESTIMONY TO HOUSE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS' HEARING ON ERISA REFORM _____ On March 9 and 10, the House Committee on Education and the Workforce Subcommittee on Employer-Employee Relations held a hearing entitled “A More Secure Retirement for Workers: Proposals for ERISA Reform.” Representative Boehner (R-OH) is chairman of this Subcommittee. On March 9, the witnesses testified on issues related to the provision of investment advice to plan participants. Witnesses included representatives from the Committee on Investment of Employee Benefit Assets (“CIEBA”), The ERISA Industry Committee (“ERIC”), the AFL-CIO, Financial Engines, the Older Women’s League (“OWL”) and Fidelity Investments, on behalf of the Investment Company Institute. The Institute also submitted written testimony. On March 10, witnesses testified regarding ERISA prohibited transaction reform. Witnesses included representatives from the American Council of Life Insurers (“ACLI”), AARP, Pension Rights Center, Securities Industry Association (“SIA”), the Bond Market Association and the Frank Russell Company. Testifying on behalf of the Institute, Margaret Raymond, Assistant General Counsel at Fidelity, made the following points: (1) the corporate defined contribution system is healthy; (2) investment education and advice are important because of the prevalence of defined contribution plans allowing participants control over investment decisions; (3) under ERISA, plan participants generally cannot obtain investment advice from their plan service providers, including mutual funds; and (4) Congress can help participants obtain the investment advice they want. In proposing that Congress provide legislative relief, Ms. Raymond noted that current fiduciary standards under ERISA and the Investment Advisers Act of 1940 provide adequate protections under federal law to enable mutual funds, and other financial institutions, to provide plan participants with investment advice. The Institute submitted written testimony to the Subcommittee. The Institute’s testimony included the following points: (1) the growth of defined contribution plans, especially participants- directed 401(k) plans, represents a significant change in the employer-sponsored pension plan environment; (2) the mutual fund industry has a long history of encouraging people to save for retirement and has contributed to the success of defined contribution plans; (3) ERISA should require that plan participants be fully and automatically informed of all relevant fees and expenses associated with the activity in their accounts; (4) although participant education is effective

for many plan participants, participants increasingly seek investment advice in addition to education; (5) current law should be amended to permit financial institutions currently prohibited from providing investment advice to participants to do so; and (6) the current Department of Labor prohibited transaction exemption ("PTE") process does not work efficiently and should be revised. 2Specifically, the Institute proposed that Congress should provide a statutory exemption from the prohibited transaction rules for the provision of investment advice if the advice provider meets the following conditions: (1) the advice provider assumes fiduciary status under ERISA and is subject to the strict fiduciary standards under ERISA section 404; (2) only regulated financial institutions are eligible to provide advice under the exemption; (3) the advice provider is required to make certain disclosures, including disclosure of all relevant fees and a description of its advisory services; (4) the advice is implemented only at the direction of the individual plan participant (i.e., the exemption should not be available to participant accounts over which the advice provider exercises investment discretion); and (5) the advice provider is required to maintain records necessary to determine whether the conditions of the exemption are met. With respect to the PTE process, the Institute recommended that current statutory standards be revised to require the Department of Labor to: (1) consider relevant, existing federal laws and regulations, such as the securities laws, already applicable to the activity for which the exemption is sought; (2) seek to minimize any inconsistencies between the conditions or requirements in any exemptive relief and other such laws, consistent with the protection of plan participants; (3) make a finding that conditions or requirements set forth in an exemption are necessary additions to the existing federal laws, regulations and the protections they afford to address concerns unique to retirement plans; (4) expedite the exemption process; and (5) clearly identify the prohibited transaction addressed in the exemption. Professor Grundfest, former SEC Commissioner and co-founder of Financial Engines, an internet-based investment advice company, testified on behalf of Financial Engines. Professor Grundfest stated that there is a real danger that mutual fund providers can and will "shade" information services (education and investment advice) to plan participants in a manner designed to promote the fund family's interest in obtaining higher fees. His testimony then described information services by an unnamed mutual fund company that, in his view, contained information that was not in the best interest of plan participants. In response to Professor Grundfest's testimony criticizing the ability of mutual fund companies to provide objective investment advice to plan participants, the Institute submitted a letter from Institute President Matt Fink to Chairman Boehner that was read into the hearing record. Grundfest's testimony provided three recommendations. First, if the adviser is independent of the fund provider, then it should not be subject to the prohibited transaction rules of ERISA and should be permitted to offer investment advice services to participants. Grundfest's definition of "independent" is as follows: (1) the adviser is not affiliated with the mutual fund provider; (2) the compensation paid to the provider is not contingent on the advice provided; and (3) the advice satisfies specified objectivity and competence criteria consistent with modern financial literature. Second, his proposal would permit mutual funds advisers to offer advice over their own funds if: (1) the funds adopt a level fee structure within the plan (e.g., all the funds would have to charge a flat 50 basis point fee); (2) the compensation paid to the adviser is not contingent on the advice provided; and (3) the advice satisfies objectivity and competence criteria that are consistent with modern financial literature. Third, Grundfest would have Congress clarify that an independent financial adviser is not prohibited from providing advice where the mutual fund provider pays all or part of the independent adviser's flat fees. The following organizations supported the development of an exemption to permit the provision of investment advice to participants by financial institutions: SIA, ACLI and Frank Russell. The employer groups, including CIEBA and ERIC, noted that employers would like to

facilitate the provision of investment advice to their plan participants, provided they would be protected from liability regarding the actual advice. ERIC, however, noted that the plan sponsor would still be responsible for 3making a prudent choice in selecting the advisory service provider. AARP supported the provision of investment advice to participants by employers and plan service providers if the advice is: (1) subject to ERISA's fiduciary standards; (2) protected from conflicts of interest; and (3) based on sound investment principles. In addition, SIA and ACLI supported requiring the Department to take into consideration other federal laws in its rulemaking process. The SIA also called for the repeal of ERISA section 406(b)(2), which prohibits a fiduciary from engaging in any transaction with a party whose interests are adverse to the interests of the plan and its participants or beneficiaries. Highlights of other witness's testimonies are as follows. The AFL-CIO opposed any weakening of the prohibited transaction rules, noting that when financial institutions provide investment advice about their own investment vehicles to plan participants, neither the Department of Labor nor plan fiduciaries can adequately monitor the conflicts of interest. OWL and AARP supported requiring defined contribution plans to have distribution requirements similar to defined benefit plans, namely the joint and survivor annuity requirement. The ACLI supported encouraging the use of "guaranteed lifetime income distribution options" in defined contribution plans. Copies of Matt Fink's letter to Chairman Boehner, the witness lists and testimony submitted by Fidelity, the Institute and Professor Grundfest are attached. Please call me at (202) 218-3563 if you would like copies of any other witness's testimony. Kathryn A. Ricard Associate Counsel Attachments

---