Testimony Before the ERISA Advisory Council on Behalf of the American Society of Pension Actuaries

Working Group on Fiduciary Education

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Thank you. My name is Bruce Ashton. I am a partner of Reish Luftman McDaniel & Reicher in Los Angeles, California. My firm specializes in employee benefits and tax matters.

I am here today to present the views of ASPPA, of which I am currently co-chair of its Government Affairs Committee and of which I will be President-Elect beginning in November. ASPPA is a professional society representing over 5,000 practitioners in the retirement plan community who provide services to over half the plans in the United States. Our members are keenly interested in ensuring timely and effective compliance with the requirements of ERISA as well as the Internal Revenue Code.

ENRON. WorldCom. and before that, First Union and Bank of New York. participants losing 80% or more of their retirement savings. We can't seem to open the newspaper or tune in to the financial news without another disastrous story of executives lining their own pockets, never considering the needs of their stockholders or (more importantly for our purposes) their employees. And these aren't just names in the news or sound bites that touch us for a moment before we move on to the weather and the sports. These stories affect real people with real losses, facing real hardships.

Congress has spent much of this year focusing on how to fix the problems brought to light in these debacles. ASPPA supports many of the proposals making their way through the legislative process, including provisions that will expand remedies available to participants and encourage employers to make investment advice more broadly available to participants. While these are laudable and in many cases necessary corrections, we believe there is an important - indeed, critical - issue that is receiving far too little attention.

This is the issue of fiduciary competence. By "fiduciary competence" I mean the ability of company executives and plan service providers to properly fulfill their fiduciary duties under ERISA.

Of course, this issue has been with us since employers first began providing retirement plans for their employees. But over the last decade its importance has been magnified. I'm sure you're well aware of the reasons -- the shift to defined contribution plans, where the participants bear the financial risk of the investments; and the shift to participant directed plans, where the participants are expected to take on the responsibility for funding their own retirement. Clearly, providing investment advice to participants will help to ameliorate the latter problem. But if the fiduciaries fail to carry out their duties in the first place, no amount of investment advice will make up for it. Put another way, even a brilliant job of asset allocating mediocre funds will still produce a mediocre result.

Let me give an example from my own practice. A large company decided to implement a participant directed 401(k) plan. The chief executive took on the task of selecting the investment options to be offered to the participants. Based on his own experience with investing and his knowledge of the financial markets, he narrowed the choice of investment providers to two. One was a large brokerage firm, and the other was a well-known mutual fund family. He made his choices for reasons he felt were perfectly valid: he had a long-standing relationship with the brokerage firm, having worked with the same broker for many years on his own investments. The other falls under the old adage, "No one was ever fired for selecting IBM." That is, everyone has heard of the provider and that provider

is managing billions of dollars, so how can the choice be bad? Fortunately, some of his colleagues insisted that the company look at these two options more carefully.

You can guess the rest. After we came in and did some investigation, it turned out that the broker - the chief executive's long-standing "friend" -- was going to receive an 80 basis point commission on all plan investments in perpetuity, without providing any services other than acting as the broker. That's 80 basis points on top of whatever other costs or investment management fees might be associated with each investment. The CEO was shocked when he learned this. Further, it also turned out that the bundled arrangement initially offered by the mutual fund family would not provide all of the services the company believed it needed. Our investigation lead to negotiations that, in the end - I'm happy to say -- produced a prudent result for the participants.

Was the chief executive in this case a "bad" fiduciary? Clearly, in one sense, yes, because he did not engage in procedural prudence in selecting the plan investment options. But in another sense, the answer is "no" because the executive was not disregarding his duties - rather he was acting out of ignorance of his duties. He did not (at least initially) understand how to fulfill his responsibilities as a fiduciary, did not appreciate that the process of selecting investment providers for a plan under ERISA involves more than picking providers that he knew, or at least thought he knew - that it required a detailed investigation up front and the need for employing professionals to assist him in an area where he might not have sufficient knowledge and experience.

What's the solution? We submit that there are two steps the DOL can and should take:

- First, the DOL should work towards developing "best practices" for fiduciary conduct, by both the in-house fiduciaries and experts hired to assist the plan; those experts, by the way, are often investment advisors who in their own right may not fully appreciate their duties under ERISA.
- Second, we believe the DOL should, in conjunction with the private sector, promote and facilitate fiduciary education, including the widespread dissemination of the best practices.

Let's examine each of these in detail.

Best Practices for Fiduciary Conduct

I'll start with another example: ERISA requires a plan to have a funding policy. But Title I says nothing about whether a plan should have an investment policy or whether that policy, if required, must be written down. We submit the plans should have both and that this should be clarified in a published standard.

But, you say, this requirement is obvious. How can a plan function, how can the plan sponsor select investment options, without having an investment policy? Well, in fact, it can't, and in reality every plan really does have an investment policy, of sorts. That is, when the plan sponsor or the plan committee selects the investments, they are necessarily carrying out an investment policy, however vague or ill-defined. Even in the example I described earlier, the CEO was operating with an investment policy of sorts. But was it coherent? Did it identify the plan's objectives? Did it identify the assets classes that needed to be covered and how the fiduciaries would go about selecting the investment options to fill each of those classes? Clearly not.

How much better it would be if fiduciaries had clear, concise guidance stating that they should prepare a written investment policy statement, and had best practices on the types of things it ought to cover and the steps they should take in selecting and then monitoring the plan's investments or investment options? Wouldn't plan participants be better off if the fiduciaries had a better road map at the beginning of the journey?

What should the best practices cover? Among others - and this is by no means an

exhaustive list - we submit it should address the following:

- The requirement of a written investment policy statement;
- The issues the IPS should cover including:
- The investment objectives of the plan;
- The investment time horizon, risk profiles and expected return for the plan;
- The investment structure of the plan - that is, identification of core investment categories and the criteria used to select them;
- Identification of the lifestyle or lifecycle funds or asset allocation models to be offered by the plan, nondesignated investment options, whether the plan offers mutual funds windows or brokerage accounts;
- The monitoring benchmarks for each investment alternative;
- The frequency of monitoring and how the plan will deal with underperforming funds;
- The types of due diligence the fiduciaries should conduct in selecting and monitoring investment options and providers, including investment managers or advisors - in this regard, the criteria established by the PWBA in the settlement of the Arizona Carpenters case a number of years ago would be useful;
- How frequently monitoring activities should be undertaken;
- The types of due diligence records the fiduciaries should retain and for how long.

Obviously, there are other practices that should be addressed, and this is merely a sample. We offer it as a potential starting point for the establishment of best practices or fiduciary guidelines. We understand that you have previously heard testimony from the Foundation for Fiduciary Studies. The Foundation has prepared proposed best practice guides for all fiduciaries, not just those subject to ERISA. While ASPPA does not endorse those guidelines, we believe they also represent a good starting point for the establishment of best practices for fiduciaries by the PWBA.

Let me address one other point here: some people may be concerned that the publication of such guidelines would hamper the PWBA's enforcement activities. We do not agree. To the contrary, if the guidelines we envision are truly "best practices," then their publication should aid the PWBA's enforcement activities in two ways:

- first, by reducing the situations in which enforcement action is required;
- second, by being able to point to the best practices as evidence of a fiduciary breach.

We would be pleased to work with the Council, this working group or the PWBA to further define and document fiduciary best practices. Now, let's turn to fiduciary education.

Fiduciary Education

There is widespread acknowledgment that a substantial percentage of 401(k) plan participants lack the sophistication to properly manage their accounts. We're seeing heroic efforts being made to bring education and advice to the participants. But consider this: if the private retirement system can be improved by providing education to participants -- who have a limited role in funding for their retirement, by which I mean their job is to make asset allocation decisions - how much better if education were provided to the fiduciaries, who have the harder job of investment selection and monitoring?

After all, the PWBA and the private sector share a common goal - to provide a meaningful and secure retirement to U.S. workers. Clearly, over the last 25 years, the duties of fiduciaries have been identified through litigation, both by the PWBA and the private sector. But we submit that leaving the definition of fiduciary duties to litigation is piecemeal, sometimes produces odd results based on odd facts, but also fails to get the information disseminated where it needs to be, to the individuals - often company executives -- who have the job of administering retirement plans.

To some degree the education of fiduciaries is being fulfilled by the market place. A number of investment providers are providing materials to assist fiduciaries in fulfilling their duties. My firm has been involved in preparing materials being used by a number of these providers, including Manulife and Nationwide, among others. We would be pleased to provide the working group with copies of such materials if desired.

But, again, as good as these materials may be, we submit that leaving investment education to the market place is still piecemeal and may fail to achieve widespread education of fiduciaries. As the PWBA has done with its brochures on plan expenses, how much better would the entire retirement system be served if the DOL were to provide educational materials for fiduciaries, both in the form of the best practices guidance we have suggested and a road mapointing out the duties of fiduciaries, specifically in participant directed plans.

The need for education and guidance for participant directed plans is especially critical, in our view, because of the dearth of formal guidance and litigation in this area. A few years ago, we did a search for the literature addressing the peculiar requirements applicable to participant directed plans. There wasn't any. We also looked for litigation in this area. There wasn't any, and still isn't much. So where do fiduciaries in these types of plans learn how to do it "right"?

The fiduciary education we envision would have several elements:

- Educational brochures published by the PWBA addressing the issues fiduciaries need to consider in administering their plan;
- Educational outreach programs by the DOL in conjunction with the private sector - similar to the programs co-sponsored with the PWBA by ASPPA and the International Foundation on the Form 5500;
- Education of DOL investigators on the particular and sometimes peculiar issues that arise in 401(k) participant directed plans, to assist the PWBA in looking for problems when they conduct investigations of these plans.

What areas should be covered in such an education program? We submit that the following elements should be included:

1. The fiduciary self-dealing prohibitions under ERISA section 406(b) and the types of compensation the fiduciaries may receive - and may not receive;

2. The requirements for agreements with plan service providers, especially the requirement that such agreements be in writing;

3. The requirement that the fiduciaries understand and document the plan's cash flow and distribution needs;

4. The requirement to maintain assets so that they are subject to the jurisdiction of the U.S. courts;

5. The trust requirement for plan assets;

6. The requirements related to the deposit of deferrals and participant loan payments;

7. The requirements regarding the plan's investment policy - which we discussed previously, but specifically addressing risk levels, expected return, investment time horizons and rebalancing guidelines;

8. The need to select diversified asset classes consistent with the IPS, especially the need to select a number of assets classes consistent with plan

size;

9. The need to conduct due diligence and maintain records in selecting investment options, investment managers and service providers;

10. The need to investigate and monitor plan expenses;

11. The need to obtain and review periodic performance reports comparing the performance of plan investments or money managers against appropriate indices, peer groups, and objectives stated in the investment policy statement;

12. The need to make periodic reviews of both qualitative and organizational changes to money managers;

13. The need to establish control procedures to periodically review a money manager's policies for best execution, soft dollars and proxy voting.

As with our suggestions for fiduciary best practices, this is not an exhaustive or exclusive list but merely a starting point. We would be pleased to work with the PWBA on these ideas -- and I would be pleased to answer any questions.

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