ASPPA President Testimony

Testimony of Scott D. Miller, President, ASPPA, before the ERISA Advisory Council

June 27, 2003

Introduction

Thank you members of the ERISA Advisory Council for this opportunity to testify on this extremely important issue. My name is Scott Miller. I am a Principal of Actuarial Consulting Group, Inc., with offices in New York and Illinois. Actuarial Consulting Group, Inc. provides actuarial, consulting, and plan administrative services for retirement plans covering thousands of participants throughout the country. Although, many of the firm's clients are small businesses with less than 100 employees, the firm also provides retirement plan services to larger firms, including Fortune 100 companies.

I am here today to present the views of ASPPA, for whom I currently serve as President. ASPPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPPA's membership is diverse, but united by a common dedication to the private pension system.

We applaud this Council's leadership in exploring whether, and where, our nation's pension laws may need strengthening. We also commend the Council for its stated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers.

Background

This Council is well aware that the 401(k) plan has become the dominant retirement plan for the American workforce. This is particularly true among workers at small to mid-sized companies. Those small business workers fortunate enough to be covered by a workplace retirement plan are in most cases going to be covered by a 401(k) type of plan. In fact, workers at these firms are only one-fifth as likely to be covered by a defined benefit pension plan than their counterparts working at larger firms. ASPPA is dedicated to a legislative and regulatory effort to expand defined benefit plan coverage among workers at these small and mid-sized firms. However, this is unlikely to change the dominance of 401(k) plans in this market.

The consequence of this is significant from the standpoint of the participant. In the case of a defined benefit pension plan the employer guarantees accrued benefits, and it is the employer, and not the employee, that bears the risk of investing the plan assets. In the case of a 401(k) plan, no such benefit guarantee exists and it is the participant who bears the risk of any 401(k) account investment losses. Further, in virtually all 401(k) plans, the responsibility of investing plan assets has been shifted away from the employer—who in many cases had the assistance of professional investment expertise—to participants without such assistance. Thus, the shift from defined benefit plan coverage to 401(k) plan coverage has resulted in participants not only bearing investment risk but also bearing investment responsibility.

Without the investment expertise to manage participants' own retirement savings and without reasonable and fair access to such expertise, the retirement security of a large segment of the American workforce is inherently at risk. Of course, this issue went largely unnoticed during the bull market of the 1990s. However, such a market cannot and did not sustain itself leaving many unprepared 401(k) plan participants totally surprised. The reality is that many more senior American workers never believed their 401(k) account would ever go down. The result is that many of these workers have either had to delay retirement or have had to seriously reevaluate their expected retirement standard of living.

This is not to suggest that access to professional investment expertise would have prevented all participant 401(k) account losses. Obviously, that would not have been the case. However, with more readily accessible investment expertise, it is certainly reasonable to suggest that participants would have been in a much better position to mitigate such losses. Unfortunately, as discussed more fully below, the law currently contains impediments restricting the ability of participants to gain access to such investment expertise.

As 401(k) plan participants face the reality of their quarterly account statements, they are increasingly cognizant of their own lack of investment experience and are expressing the desire to obtain access to such expertise. ASPPA members who frequently meet with 401(k) plan participants to discuss plan investment options and provide general investment education consistently encounter the frustrations of plan participants who want advice and instructions specific to them. If policymakers expect plan participants to bear investment risk and if they expect plan participants to bear investment responsibility, they must recognize the need to change both the law and regulations where necessary in order to provide 401(k) plan participants with the proper tools to allow them to effectively save for retirement.

The Investment Advice/Education Trap

The desires of plan participants to have more specific investment advice for their 401(k) account investments has created a trap for the retirement plan industry. Responding to Department of Labor regulations, many sectors of the industry have conditioned themselves to only provide general retirement education to participants, not individual advice. The distinction is significant because the giving of advice is a fiduciary act making the advisor a fiduciary. Many retirement plan service providers, even those unaffiliated with investment companies (e.g., mutual fund companies; insurance companies), receive fees from plan assets. If such service providers also provide investment advice, they will be violating the current prohibited transaction rules. However, the pressure from plan participants to get individual advice can often be substantial. The harsh reality is that faced with such pressure, retirement plan service providers commonly cross the line and provide investment advice. They do so despite the prohibited transaction rules, either knowingly or perhaps more often unknowingly.

For purpose of background, under Department of Labor rules, providing the following types of information are not considered to be rendering investment advice:

1. Information about the plan, including the benefit of plan participation and information required by 404(c);

2. General financial information about investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment; historic differences in rates of return between different asset classes (e.g., equities, bonds, or cash) based on standard market indices; effects of inflation; estimating future retirement income needs; determining investment time horizons; and assessing risk tolerance;

3. Asset allocation models, so long as they are provided to all participants and are based on generally accepted investment theories; and

4. Interactive investment materials, such as questionnaires, worksheets, software, and similar materials, which provide a participant or beneficiary the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income.

[DOL Reg. §2509.96-1(d)]

By contrast, in Interpretive Bulletin 96-1, the Department of Labor defined investment advice:

a person will be considered to be rendering “investment advice,” within the meaning of ERISA section 3(21)(A)(ii), to a participant or beneficiary only if: (i) the person renders advice to the participant or beneficiary as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property ([DOL Reg. §] 2510.3?21(c)(1)(i)); and (ii) the person, either directly or indirectly, (A) has discretionary authority or control with respect to purchasing or selling securities or other property for the participant or beneficiary ([DOL Reg. §] 2510.3?21(c)(1)(ii)(A)), or (B) renders the advice on a regular basis to the participant or beneficiary, pursuant to a mutual agreement, arrangement or understanding (written or otherwise) with the participant or beneficiary that the advice will serve as a primary basis for the participant's or beneficiary's investment decisions with respect to plan assets and that such person will render individualized advice based on the particular needs of the participant or beneficiary ([DOL Reg. §] 2510.3? 21(c)(1)(ii)(B)). (Emphasis added)

[DOL Reg. §2509.96-1(c)]

Under this description, there is a two-pronged test for information given to participants to be considered investment advice. First, there must be advice regarding the value of securities or recommendations considering the actual investment choices. Second, the person giving the advice must either have discretion over the participant's account or must render the advice on a regular basis with the understanding that the advice is the primary basis for the participant's investment decisions and is individualized advice to the participant. Ultimately, in today's volatile investment marketplace it is investment advice, not education, that participant's desire and need most.

This is not to say that investment advice that comports with the prohibited transaction rules is not available. For example, there are many qualified and talented independent individual investment advisors. However, in many cases the cost of such individual independent advisors can be prohibitive on a per participant basis, particularly for smaller employers. Alternatively, there are computer-based advice tools that can be extremely effective and are relatively cost efficient. However, utilization of these computer-based tools remains relatively insignificant in the retirement plan marketplace, although it is definitely increasing.

Reasons for the lack of utilization of computer-based advice tools, particularly among smaller employers, may be the result of still fairly high set-up costs especially where plan recordkeeping is not through a large financial institution. Even more significantly, the lack of utilization of computer-based advice tools, for both small and large employers, may be the potential fiduciary liability that can be incurred by plan sponsors for offering investment advice. One of the most attractive features of 401(k) plans to employers is that they are shielded from any fiduciary liability resulting from participants' exercise of control over the plan investment options, provided they satisfy the requirements of ERISA section 404(c). However, the selection of an investment advisor is a fiduciary act by the plan sponsor who then also has a fiduciary responsibility to monitor the activities of the investment advisor. Surveys by the Institute of Management and Administration consistently show that potential fiduciary liability, not the cost of advice, is by far the major reason employers choose not to offer investment advice to employees.

In 2002, Senators Bingaman (D-NM) and Collins (R-ME) introduced legislation in response to these employer concerns. The approach taken in S.1971 and S.1992 was to create a fiduciary liability safe harbor for the employer who designates an investment advisor for the plan. The employer would be deemed to satisfy its responsibilities regarding the prudent selection and periodic review of an investment advisor. The employer also would not be liable for any losses resulting from such investment advice, including co-fiduciary liable (except for knowing participation in, or concealment of, an advisor's breach). Further, the employer would not have to monitor the specific investment advice being given to any particular participant.

In order to have safe harbor protection, the employer would have to appoint a qualified investment advisor. A qualified investment advisor includes: (a) a registered investment advisor, (b) bank, (c) insurance company, (d) other comparable entity (as determined by DOL), or (e) any employee or agent of a person described in (a) through (d), if the employee or agent is a registered investment advisor, registered broker/dealer, registered representative, or any other comparably qualified individual (as determined by DOL).

The safe harbor would not be available unless the qualified investment advisor's relationship with the plan does not violate current prohibited transaction rules. In other words, the fiduciary liability safe harbor would only be available to the extent the investment advisor is independent (i.e., does not receive any fees from plan assets). In addition, the qualified investment advisor would have to provide annual verification to the employer that: (a) the advisor is qualified and is a fiduciary with respect to the plan, (b) the advisor's relationship with the plan is not a prohibited transaction, (c) the advisor will consider any employer securities and employer real property allocated to the participant's account, and (d) the advisor has adequate fiduciary insurance coverage.

In April 2003, the House of Representatives passed legislation generally addressing concerns arising out of the demise of Enron that took a very different approach to promoting participant investment advice. As discussed earlier, financial institutions wishing to provide investment advice services to participants are often precluded from doing so because of prohibited transaction issues arising with respect to the fees received from plan assets (e.g., investment options in the plan that assess management fees paid from plan assets are offered through an affiliate of the investment advisor).

The House bill would permit these financial institutions to render advice to plan participants despite the receipt of fees from plan assets provided certain requirements are satisfied. The approach taken in the House bill is to grant a prohibited transaction exemption for investment advice rendered by certain "qualified fiduciary advisors." The investment advisor would be subject to certain disclosure requirements, which include: (1) fees (including commissions) that the advisor would receive with respect to any advice on investments available under the plan, (2) the relationship between the advisor and the investments offered, (3) any limitations on the scope of the advice, and (4) the types of services offered by the advisor. Also, the advisor would have to acknowledge in its disclosures that it is acting as a fiduciary with respect to the rendering of investment advice, and inform the participant of his/her right to arrange for an independent advisor. These disclosures would be required at the time the investment advice is initially made available, and then annually thereafter (or when there is a material change, if sooner).

In addition, under the House bill (1) all fees and commissions would have to be reasonable; (2) the terms of any sale of investments would have to be at least as favorable to the participant as an arm's length transaction; (3) a qualified fiduciary advisor would include: (a) a registered investment advisor, (b) bank, (c) insurance company, (d) registered broker/dealer, (e) an affiliate (including an employee) of a person described in (a), (b), (c) or (d), or (f) an agent or registered representative of any such person, if applicable insurance, banking, or securities laws regarding advice are satisfied.

In light of recent controversial events surrounding the securities industry, including a recent settlement between the securities industry and the Securities and Exchange Commission respecting certain conflicts of interest, the House bill approach has been opposed as being too broadly crafted. Although ASPPA understands these concerns, ASPPA believes that under certain situations the prohibited transaction exemption provided under the House bill would be appropriate. For example, where the investment advisor receives fees from plan assets (e.g., a flat percentage of account assets) but is unaffiliated with the investment management company there is really no conflict of interest. In addition, if the advice is based on an independent computer model a prohibited transaction exemption might be appropriate (similar to that granted by the Department of Labor to Sun America), despite the fact that the advisor actually delivering the advice is affiliated with the investment management company. There may be other similar circumstance where a prohibited transaction exemption might be appropriate, despite the technical existence of a conflict. These circumstances should be explored.

Notwithstanding proposals to provide prohibited transactions exemptions for rendering investment advice, ASPPA strongly believes that any legislation to promote participant investment advice must also in some way address plan sponsor concerns about potential employer fiduciary liability. Otherwise, large numbers of employers will not offer this valuable and important tool to plan participants.

The Emergence of Investment Management as an Option

In response to continuing frustrations expressed by 401(k) plan participants over their responsibility to invest their account assets, a new investment alternative appears to be developing. A large mutual fund company (the "Investment Manager") recently announced that it would provide investment management for 401(k) plan participants using its own funds and alliance funds that pay revenue sharing to the Investment Manager. Participants must have at least $10,000 in eligible plan assets to use the service. This structure raises two issues: First, does this violate the nondiscrimination rules, which could cause a plan to be disqualified? Secondly, is this a violation of ERISA's prohibited transaction rules because the Investment Manager could direct participants to invest in its mutual funds?

For clarity, we should distinguish between investment management and investment advice. An investment advisor makes recommendations, but does not have the independent authority to implement them. An investment manager makes and implements investment decisions. However, both investment advice and investment management are tools for solving the lack of basic investment knowledge faced by many participants. Both are valuable 401(k) services and both are fiduciary activities.

There are policy and technical issues raised by the advent of an investment management alternative. Under the option recently announced, the Investment Manager will make its new service available only to participants with account balances of $10,000 or more. Although the limitation is understandable given the cost associated with providing personal investment management, it certainly raises fairness issues. A recent study by the Employee Benefit Research Institute indicated that 45% of 401(k) participants have account balances of less than $10,000—and presumably these accounts are primarily held by non-highly compensated (NHCE) employees. This limitation also raises a significant technical issue. It is likely, given the limitation, that the Investment Manager's new service will be proportionately skewed towards the highly compensated employee (HCE) population. This, of course, raises the concern that a plan using this service would discriminate in favor of highly compensated employees (HCEs)—potentially in violation of Code section 401(a)(4).

Qualified retirement plans must make benefits, rights and features (BRFs) available in a nondiscriminatory manner. [Treas. Reg. § 1.401(a)(4)-4(a).] The definition of BRF includes all optional forms of benefits, ancillary benefits and other rights and features available to any employee under the plan. [Treas. Reg. § 1.401(a)(4)-4(a).] The term "other right or feature" generally means "any right or feature applicable to employees under the plan." [Treas. Reg. § 1.401(a)(4)-4(e)(3)(i).] There is an exception for rights or features that "cannot reasonably be expected to be of meaningful value to an employee (e.g., administrative details)." [Treas. Reg. § 1.401(a)(4)-4(e)(3)(ii)(C).]

The opportunity to use investment management services (or to receive investment advice) is not specifically listed as a right or feature. However, the Treasury regulations include the right to direct investments and the right to a particular form of investment in the definition of rights or features. The regulations also state that the list is not exclusive. Further, the right to use an investment manager does not appear to fit within the "no meaningful value" exception, as evidenced by what participants are charged for investment management. As a result, ASPPA has concerns that the investment management alternative would be considered an "other right or feature," subject to the qualification requirements for nondiscrimination.

As such, the rights to investment management must be both currently and effectively available to employees, based on the relevant facts and circumstances. Treas. Reg. § 1.401(a)(4)-4 provides a safe harbor for the current availability requirement satisfying the ratio percentage test (i.e., the percentage of NHCEs to whom the BRF is available equals or exceeds 70% of the HCEs to whom the BRF is available). However, there is no safe harbor for the effective availability requirement. For effective availability, the right must not substantially favor HCEs based on the relevant facts and circumstances. In light of this, ASPPA believes that the question of how the qualified plan nondiscrimination rules apply to the investment management alternative should be clarified so that plan sponsors know with certainty how to offer this option.

The Investment Manager alternative investment option also raises prohibited transaction issues. ERISA § 406 (b)(1) prohibits a fiduciary from using the plan's assets for his or her own interest. DOL Reg. § 2550.408b-2(e)(1) states that "a fiduciary may not use the authority, control, or responsibility which makes such a person a fiduciary to cause a plan to pay an additional fee to such fiduciary." ERISA § 3(21)(A) defines a fiduciary as, among other things, a person who manages plan assets. Thus, an investment manager is a fiduciary under ERISA. As a result, 406(b)(1) prohibits an investment manager from using its authority to cause the plan to pay it an additional fee, unless the manager fits within an exception to the rule. Thus, without an exception, the Investment Manager would be committing a prohibited transaction when it used its own funds in a managed account.

Over 25 years ago, the DOL issued a prohibited transaction class exemption (PTCE 77-4) that provides relief from ERISA § 406(b)(1) if certain requirements are met. The class exemption provides that an investment manager for participants, who is also an investment advisor to a mutual fund, may make recommendations to the plan about funds, including the fund it advises, so long as:

- · No commission is paid in connection with the plan's purchase of the mutual funds (which eliminates broker-sold investments);

- · No redemption fee is paid upon sale of the mutual funds, unless it is only paid to the fund and the investment manager does not share in the fee;
- · An independent fiduciary (e.g., the plan committee) approves the selection of the investment manager and approves its compensation; and
- · The investment manager offsets the advisory fee it receives from the mutual fund against the fees it charges the plan participant investment management services.

ASPPA understands the Investment Manager intends to satisfy these requirements. Based on its press release, the Investment Manager will charge the participant a fee of between 0.85% (85 basis points) and 1.10% (110 basis points) of the account balance (depending on the size of the account), but will give the participant a credit against this up to 50 basis points for the fees the manager is paid by the mutual funds for acting as investment advisor to those funds. Thus, the net charge to the participant will be approximately 35 and 65 basis points, depending on the size of the account (unless the investment management fee is less than 0.50%—50 basis points—in which case the net fee for participant-level management will be correspondingly higher). In addition, ASPPA has learned that the Investment Manager intends to offset the compensation it receives on the alliance funds offered in its platform (i.e., the mutual funds for which the Investment Manager does not perform fund advisory services).

Since no brokerage commission will be paid on the sale of the funds and the arrangement will be approved by an independent fiduciary of the plan, it appears that this new service will fall within the class exemption, at least on the Investment Manager's own funds. However, there is some concern that the class exemption would not apply to the alliance funds, since the class exemption is limited to the situation of an investment manager acting as a fiduciary for the selection of mutual funds for which it also serves as the fund advisor. However, the DOL concluded in Advisory Opinion 97-15A that a fiduciary did not engage in a prohibited transaction where it offset the amount of compensation it received from third parties against the fees it charged a plan. Thus, for the revenues received on the alliance funds, the Investment Manager could arguably rely on the Advisory Opinion.

It is too early to tell how plan sponsors and plan participants will receive this alternative. However, ASPPA believes that given the potential importance of this new investment alternative, the DOL should issue new guidance that more clearly delineates the circumstances under which the Investment Manager alternative, as well as similar alternatives, satisfy the prohibited transaction rules.

Conclusion

ASPPA greatly appreciates this Council's interest in ways to provide 401(k) plan participants the right tools they need to effectively handle the investment responsibilities they have over their accounts. The retirement security of American workers will certainly be enhanced if we can make these tools more readily available.

I would be pleased to answer any questions you may have.

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