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On Behalf of
The American Benefits Council

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Working Group on Select Issues of a
Procedurally Prudent Investment Process

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Good morning and thank you for the opportunity to appear today. I am Jason Bortz, a partner at the Washington DC law firm of Davis and Harman LLP.

I am here representing the American Benefits Council, a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to employee benefit plans covering more than 100 million Americans.

I would like to start by commending you for taking steps to focus attention on procedural fiduciary responsibility in the context of retirement plans that provide for participant investment direction. It has been nearly 15 years since the Department of Labor issued final regulations under section 404(c) of ERISA. These regulations are an important part of fiduciary compliance in defined contribution plans but they can be improved. The 404(c) regulations were issued before the advent of the internet and e-mail and the regulations need to be updated. Moreover, far too few plans are able to, or even try to, satisfy the many procedural requirements of the 404(c) regulations. The time is ripe to take a new look at these regulations and see if the 404(c) safe harbor can be made more attractive to plan fiduciaries and more effective in helping plan participants to manage their accounts.

To this end, my testimony will make suggestions for improving the regulations under section 404(c). Specifically, my testimony today will focus on: (1) improving the information disclosure requirements of 404(c); (2) enhancing electronic delivery of required disclosures; (3) clarifying how the new investment mapping rules in pending pension legislation should be applied; and (4) clarifying the scope of ERISA's fiduciary rules in the context of open brokerage windows that are offered under 404(c) plans.

Disclosure Requirements

The Council strongly supports the appropriate disclosure of useful information to participants regarding their investment options. Participants can effectively exercise control over their accounts only if they have access to key information about a plan's investment options. It is important, however, that disclosure not overwhelm participants. It is clear that too much information can cause decision-making paralysis in participants and we believe that a careful balance is needed between providing either too much or too little information.

The mix of information under the current 404(c) regulations that either must be affirmatively provided or must be available upon request needs to be reconsidered. Under the current 404(c) regulations, a plan is required to provide the following information with respect to each investment option: (i) a general description of the investment objectives and risk and return characteristics of the option, (ii) identification of any designated investment managers, (iii) a description of the relevant transaction fees and expenses, and (iv) for any security that is registered under the Securities Act of 1933, a prospectus immediately following the participant's initial investment. Other information, such as a description of the annual operating expenses for each option, must be made available upon the request of participants.

As a threshold matter, we question the extent to which all of the information in a full blown prospectus is appropriate. We believe that a simple 2-3 page summary of the key information regarding each investment option combined with access to any full prospectus upon request (e.g., through electronic means) makes more sense than affirmatively providing a complete prospectus. An advisory opinion issued in 2003 by the Department of Labor endorses this approach by indicating that a summary prospectus or "profile" may be used to satisfy the prospectus delivery requirement in the section 404(c) regulations.[1] We believe that this rule should be made explicit as part of the regulations and that the regulations should clearly state that plans may develop their own profiles (as opposed to using only profiles developed by the funds for securities law purposes). There is little question that this type of summary form would provide the key information that participants need to make informed investment decisions without creating the information overload that a full blown prospectus can generate.

Similarly, we question the utility of the requirement that a plan deliver a prospectus to a participant following his or her initial investment in an investment option. Unlike retail investments, the universe of potential investments in a defined contribution plan is typically known at the start of participation so that all relevant information can be provided prior to the first investment decision. This strongly suggests that disclosure of investment information is most logically provided at the start of participation, not after the initial investment. While this is obviously impractical if the required disclosure includes full blown prospectuses for all registered investment options, it may well be

[1] Advisory Opinion 2003-11A (Sept. 8, 2003).

practical if short profiles are permitted in lieu of full blown prospectuses. In this regard, profiles for the available investment options could be included as part of providing participants with basic information regarding the plan, for example, as part of the summary plan description (SPD), with subsequent updates to reflect changes in investment options. This simple change would be a material improvement in the administrative complexity of the current 404(c) regulations and could help to encourage more plans to strive to be 404(c) compliant.

We also believe that the regulations should establish a core set of required disclosures that a plan must satisfy in order to fall within the 404(c) safe harbor and provide a model format for disclosure of that information. The current regulations merely state a minimum threshold and do not provide comfort that satisfaction of this minimum will result in safe harbor protection. Rather, the clear implication of the 404(c) regulation is that more is required. This leaves plan fiduciaries with little comfort that they are within the safe harbor. Accordingly, we recommend establishing a short list of required disclosures that, if satisfied, result in satisfaction of the disclosure requirements of section 404(c). These requirements would generally entail the key information that must be included in a summary prospectus.

While we have not attempted to catalog the appropriate requirements, we would be happy to provide further input to the Advisory Council and the Department of Labor at an appropriate time. It is critical that any list of required disclosures achieve the goal of providing a clear and simple description of the salient features of an investment option without excessive legalese or information overload. Other information could be made available upon request at no charge (typically through an electronic means, such as a company intranet).

One of the advantages of a uniform set of required disclosures would be to clarify the status of investment options that are not registered under the Securities Act of 1933. The current 404(c) regulation is effectively silent regarding the disclosure requirements that apply to investment options that are exempt from registration, such as collective investment trusts, insurance company separate accounts, and so-called 81-100 trusts. These arrangements are increasingly common in large plans as a means of taking advantage of economies of scale and providing participants with the most favorable fee arrangements available. However, the disclosure requirements for these funds are extremely nebulous. Many large plans create information that is comparable to a prospectus but there is no explicit requirement or guidance on these disclosures. We believe that the 404(c) regulations should establish a uniform set of disclosure requirements that apply to all investment options -- both retail and nonretail. These disclosures should provide participants with useful information regarding their investment options.

Electronic Delivery

An important aspect of information disclosure in 404(c) plans is facilitating electronic delivery. The Department of Labor has established an extremely stringent standard that makes electronic delivery of investment information almost impossible. Under the Department of Labor's regulations, electronic delivery of information required under section 404(c) is permitted only if use of the employer's electronic system is an integral part of the employee's duties or the participant has affirmatively consented to electronic delivery in a manner that reasonably demonstrates the participant's ability to access information in the electronic form.[2] This standard has proven to be a material barrier to 404(c) compliance because, in the vast majority of situations, it requires consent and proof that electronic delivery is effective to establish actual receipt.

To our mind, the standard recently proposed by the Internal Revenue Service with respect to notices and disclosures required under the Internal Revenue Code with respect to employee benefit plans strikes a more reasonable balance between facilitating electronic delivery of information and ensuring access.[3] The Service standard depends on whether the electronic medium is reasonably accessible to participants. The plan needs to provide a statement that a participant may request a paper copy of any notices at no charge, but the default is that electronic notices may be provided absent an election to the contrary. We believe application of this standard under section 404(c) would be an enormous improvement to current law. More generally, we believe this standard should be considered as the standard applicable under ERISA generally. Further, as reflected in the Service's proposed regulations, this approach is entirely consistent with the requirements of E-Sign.

More generally, the Council strongly believes that the Department of Labor should allow plan fiduciaries to satisfy certain of their disclosure obligations by posting information on company intranet sites or secure internet sites. As a practical matter, many plans provide that investment changes are made electronically and participants are increasingly facile in terms of accessing information about their retirement accounts on the internet. This needs to be reflected in the section 404(c) regulations. The Department should revisit the extent to which information must be affirmatively provided or can be satisfied through posting. For example, we believe that it should be permissible for plan fiduciaries to provide an initial disclosure detailing the characteristics of investment options as part of the plan's SPD coupled with a disclosure that investment profiles and other investment information are available on an internet site (subject to a right to opt into paper disclosure).

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[2] DOL Reg. section 2520.104b-1(c).

[3] 70 Fed. Reg. 40675 (July 14, 2005).

Mapping

A related set of issues is raised by the extent to which changes in a plan's investment menu will cause the plan to lose all or some of its 404(c) protection. The recent House- and Senate-passed pension legislation[4] amends section 404(c) to extend the section 404(c) safe harbor to a "qualified change in investment options," whereby a participant's account is reallocated among one or more remaining or new investment options which are reasonably similar in characteristics, including risk and rate of return to the prior options, provided that adequate notice is provided and the prior investments were the result of the participant's investment control.

This new legislation raises at least two issues that need to be addressed. The first issue that needs to be addressed is the fiduciary standards that apply where there is no comparable investment option. This issue arises quite frequently, for example, where a plan is paring down on the number of investment options to make the investment menu more user-friendly. Similarly, it may arise in the mergers and acquisitions context where an employer is eliminating a company stock fund option. We believe the best approach is to develop guidance that addresses the intersection of the mapping safe harbor and the new to-be-issued guidance on default investments. In this regard, it should be appropriate for the plan to invest such amounts in the plan's default investment. In fact, we believe that this is fairly common industry practice today in mapping and that it is consistent with the idea that participants are effectively making an election into the default so long as the consequences of failing to make an affirmative election are disclosed in advance.

The second issue deals with how plan fiduciaries can determine whether a substitute fund is similar, including in terms of risk and return characteristics. Without some guidance and certainty on how to make this determination, the value of the safe harbor would be significantly diminished. That is, if the determination is simply to be made on the basis of all the facts and circumstances, it will be unclear in many (if not most) situations whether the safe harbor is available. For this reason, we recommend a bright line safe harbor coupled with a flexible general rule.

Specifically, we recommend creating a safe harbor that provides 404(c) relief for any mapping change to the extent that an option is mapped to a fund that is similar determined using a standard industry assessment created by an independent third-party financial institution, e.g., Morningstar. These standard industry assessments are typically reflected in the so-called "style boxes" that describe mutual funds. We recognize that style boxes do not capture all of the refinements of various funds, for example, a style box may not reflect that one mid-cap fund is more aggressive than another. However, style boxes would provide a bright line test and the selection of any replacement option would be subject to general fiduciary standards to ensure the selection of an appropriate

[4] Section 621 of H.R. 4, The Pension Protection Act of 2006. H.R. 4 was approved by the full House on July 28, 2006 and the full Senate on August 3, 2006. The President is expected to sign the bill into law shortly.

investment option. Further, this level of simplification could have enormous benefits to plan fiduciaries and participants by making fiduciaries more willing to make changes.

Standard industry assessments will not be available to collective trusts and other non-publicly available investment options. In addition, there may be situations where the plan fiduciary determines that two funds are sufficiently similar for mapping, notwithstanding that the two funds have somewhat dissimilar style boxes. For these reasons, any guidance would need to be absolutely clear that reliance on standard industry assessments is merely a safe harbor. To this end, the regulations should prescribe very general standards and allow plan fiduciaries to exercise their best judgment. The use of a general standard is appropriate in large part because the mapping safe harbor is contingent upon the plan fiduciary providing adequate notice to affected plan participants so that they have the opportunity to exercise control over their account balances. In this regard, the fact that notice is an integral part of mapping relief strongly counsels for a liberal approach in structuring the minimum requirements for satisfying the similar investment option rule.

Brokerage Windows

Some have suggested that ERISA's general fiduciary requirements demand an evaluation of the investment acumen of eligible participants when a plan fiduciary decides to offer an open brokerage window. We are very concerned about any test based on the sophistication of plan participants. We simply do not see such an approach as viable. There are far too many variables for plan fiduciaries to make judgments about the sophistication of plan participants.

Such a test also would appear to be inconsistent with the fabric of ERISA. It is clear that there is no general standard of suitability to determine, for example, whether to provide participants with the right to direct their investments in the first place. Similarly, there is no comparable test when a plan fiduciary decides to offer a large investment menu (with more tailored funds) as opposed to a smaller menu with only a few funds. For this reason, we do not believe that an ERISA fiduciary overlay with respect to open brokerage windows is appropriate.

In our view, the best approach is the approach taken under current law. Under existing securities laws, brokers may only allow suitable investors to open brokerage windows. These rules, typically referred to as "know your customer" rules, provide significant protections that will keep only appropriate investors from utilizing a brokerage window. In our experience, these rules have been effective gatekeepers and we are not aware of any perceived or reported abuses related to open brokerage windows. Accordingly, we do not see any demand for stringent or special fiduciary standards in this area.

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Thank you for the opportunity to testify today, and I welcome any questions you may have.