TESTIMONY OF ROBERT G. CHAMBERS ON BEHALF OF

AMERICAN BENEFITS COUNCIL

AND

PROFIT SHARING/401k COUNCIL OF AMERICA

AND

SOCIETY FOR HUMAN RESOURCE MANAGEMENT

BEFORE THE

COMMITTEE ON WAYS AND MEANS

OF THE

U.S. HOUSE OF REPRESENTATIVES

FOR THE HEARING ON

DEFINED BENEFIT PLAN FUNDING LEVELS AND INVESTMENT ADVICE RULES

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TESTIMONY OF ROBERT G. CHAMBERS ON BEHALF OF THE AMERICAN BENEFITS COUNCIL, THE PROFIT SHARING/401k COUNCIL OF AMERICA, AND THE SOCIETY FOR HUMAN RESOURCE MANAGEMENT ON INVESTMENT ADVICE RULES

Introduction

My name is Robert G. Chambers, and I am a partner in the international law firm of McGuireWoods LLP. I have advised clients with respect to 401(k) plan issues since 401(k) was added to the Internal Revenue Code in 1978. In that regard, my clients have included both large and small employers that sponsor 401(k) plans as well as many financial institutions that provide services to 401(k) plans. I am testifying today not only as an adviser to my clients but also as a plan sponsor. McGuireWoods sponsors a 401(k) plan for approximately 2,600 participants. Since 2005, our plan has provided participants with much needed investment advice.

I am here today on behalf of the American Benefits Council (the "Council"), the Profit Sharing /401k Council of America ("PSCA"), and the Society for Human Resource Management ("SHRM"). I am also a past chair of the Board of Directors of the Council. The Council is a public policy organization representing plan sponsors, 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 retirement and health plans that cover more than 100 million Americans.

PSCA is a national non-profit association of 1,200 companies and their six million employees that advocates increased retirement security through profit sharing, 401(k), and related defined contribution programs to federal policymakers. It makes practical assistance available to its members on profit sharing and 401(k) plan design, administration, investment, compliance, and communication issues. Established in 1947, PSCA is based on the principle that defined contribution partnership in the workplace fits today's reality. PSCA's services are tailored to meet the needs of both large and small companies, with members ranging in size from Fortune 100 firms to small entrepreneurial businesses.

SHRM is the world's largest association devoted to human resource management. Representing more than 250,000 members in over 140 countries, the Society serves the needs of HR professionals and advances the interests of the HR profession. Founded in 1948, SHRM has more than 575 affiliated chapters within the United States and subsidiary offices in China and India.

Thank you for the opportunity to testify today regarding the provision of investment advice to defined contribution plans and their participants. The events of the past year have highlighted the importance of increasing the availability and provision of sound investment advice to the millions of Americans who rely on their 401(k) plan and other defined contribution plans for their retirement security.

Summary

In the last several months, there has been an active public policy discussion of the investment advice provision enacted in the Pension Protection Act of 2006 (the "PPA"). As discussed below, the PPA expanded the means by which investment advice can be provided to defined contribution plan participants regarding how to invest amounts allocated to their plan accounts. In addition, in January of this year, the Department of Labor ("DOL") issued regulations under the PPA investment advice provision, as well as a class exemption ("2009 class exemption") that facilitates additional means of providing advice. Neither the regulations nor the class exemption has gone into effect, as the effective date of both has been delayed by the DOL.

While the PPA investment advice provision played a constructive role in seeking to broaden the menu of permissible investment advice approaches, that provision is not my focus today. I am here to make one key point. If legislation is enacted with respect to the PPA investment advice provision, it is critical that the legislation not adversely affect the investment advice rules in effect prior to the enactment of the PPA. Participants need investment advice now more than ever.

A large number of our plan sponsor members provide investment advice to their plan participants under the pre-PPA rules. For example, it is our understanding that approximately 20 million participants in 401(k)-type plans are offered advice products based on the "SunAmerica" Advisory Opinion discussed below. The pre-PPA rules were carefully drafted to avoid conflicts of interest and to ensure that all advice programs operate in the interests of the participants. And our plan sponsors would not offer advice programs that work any other way.

Unfortunately, in the context of repealing the PPA investment advice provisions, the Education and Labor Committee approved a bill that goes much further than that, invalidating many (if not most) pre-PPA non-conflicted advice arrangements as well. The Education and Labor Committee set out to improve the quality of investment advice. However, the bill's broad reach would, in fact, cause a huge reduction in the provision of sound non-conflicted advice by invalidating pre-PPA arrangements. The effect of this reduction in advice arrangements would be very adverse, because, as noted, today, more than ever, participants need advice to get them back on course toward retirement security. In a very large number of cases, the following types of non-conflicted advice would be prohibited or made much more expensive and cumbersome by the Education and Labor Committee bill.

- **"SunAmerica" advice.** As discussed further below, under a SunAmerica advice program, participants receive advice based exclusively on a computer model designed by a third party that (1) has no financial stake in which investment options participants elect and (2) is independent of the financial institutions providing investment products to the plan.

- **Level-fee arrangements.** Again as discussed further below, under a pre-PPA level-fee arrangement, an advisor and all of its affiliates receive the same fee, regardless of which investment options are chosen by the participants. Clearly, such advice is conflict-free.

- **Managed accounts.** Under a managed account, a participant directs the advisor to automatically implement the advisor's investment advice. Many of our members have indicated that generally those arrangements, which are often based on either SunAmerica models or pre-PPA level-fee arrangements, are the most effective advice programs. One important reason for that effectiveness is that once elected, the implementation of advice occurs automatically, rather than relying on participants for implementation.

- **Exemptions.** Since the enactment of ERISA in 1974, the DOL has had the authority to allow advice that is otherwise prohibited if there are sufficient safeguards so that the advice is in the interest of the participants. For over 30 years, Democratic and Republican administrations have carefully used their authority to grant important exemptions with respect to investment advice, most or all of which would be invalidated by the Education and Labor Committee bill.

- **Plan-level advice.** Certain forms of non-conflicted advice to plan fiduciaries would be prohibited by the bill.

Our plan sponsors have made the following very clear to us: if the Education and Labor Committee bill is passed by Congress and invalidates their advice program or adds materially to its costs, they would not re-establish a new program in the near future. Unfortunately, this is not a time when companies have the time or resources to engage in expensive redesigns of voluntary programs. So millions of Americans would lose access to investment advice. This is not the time to cause Americans to lose access to advice programs.

Set forth below is a more detailed discussion of the evolution of the investment advice issue, which provides more background explaining the points summarized above.

<u>Prior to the Pension Protection Act.</u>

Prior to the PPA, the prohibited transaction rules generally prohibited any provision of investment advice where the advisor could benefit based on the advice given. The only exception to this rule was for class and individual exemptions granted by the DOL, where the DOL had specifically determined that an advice arrangement had enough safeguards in place to remove or substantially diminish any real or potential conflict, so that the use of such arrangement was in the best interests of the participants.

Prior to the PPA, it was clear that certain advice arrangements did not involve any conflict of interest and thus did not violate the prohibited transaction rules. For example, many advice arrangements relied on a DOL Advisory Opinion generally referred to as "SunAmerica". Under SunAmerica, generally a plan advisor, which may be a financial institution, arranges for advice to be given to participants (or implemented automatically, in the case of managed accounts) based solely on a computer model designed and exclusively controlled by an independent third party. The advisory opinion articulates a very specific and objective rule for determining whether the third party is truly independent. Because all advice is provided pursuant to an independently designed computer model, and because that advice cannot be modified by the plan advisor, the advice is not conflicted and there is no prohibited transaction.

Another example of non-conflicted advice is advice given by an advisor that receives the same compensation regardless of which investment option is chosen (the "pre-PPA level fee rule"). This rule was very strictly applied before the PPA. So, for example, if advice is given by an employee of a financial institution, the investment option chosen cannot affect the compensation received by the employee, the financial institution, *or any affiliate of the financial institution*.

Both of these examples—SunAmerica and pre-PPA level-fee arrangements—reflect conscious efforts to design a non-conflicted advisory platform. In addition, both types of arrangements can permit the offering of both traditional advice (whereby a participant decides whether to implement each piece of advice) and managed accounts (whereby the advice is automatically implemented pursuant to prior consent by the participant).

<u>The PPA Level-Fee Rule and the Class Exemption Level-Fee Rule.</u>

The PPA created two exceptions to the prohibited transaction rules described above, solely for use with traditional advice (i.e., they are not available for managed accounts). Under the first exception, the PPA created a new version of the level-fee rule. Under the "PPA level-fee rule", investment advice to a participant is permitted as long as the investment options chosen cannot affect the compensation of (1) the advisor giving the advice or (2) the entity employing the advisor. However, unlike the pre-PPA level-fee rule, the PPA level-fee rule permits variation in the compensation of an affiliate of that entity. So, for example, if an entity provides investment advice to plan participants, it would be permissible for a recordkeeping affiliate of the entity to receive different levels of compensation based on which investment option is chosen. The rationale for the PPA level-fee rule was that if the actual providers of the advice are not operating under a conflict of interest, the advice rendered will not be biased. In addition, as a condition of the PPA level-fee rule, the PPA requires the advisor to acknowledge that it is acting in a fiduciary capacity when providing advice and requires annual audits and extensive disclosures to the participants regarding the relationships among the parties and the fees potentially received by the affiliate.

The DOL took an additional step in the 2009 class exemption (issued in January of 2009), the effective date of which has been delayed. Under the "class exemption level-fee rule", investment advice to a participant is permitted as long as the investment options chosen cannot affect the compensation of the advisor giving the advice. The compensation of the advisor's employer or such employer's affiliate may, however, vary based on the investment option chosen. The rationale for the 2009 class exemption is as follows: if the compensation of the advisor who is actually providing the advice is unaffected by which investment option is chosen, the advice will be impartial. Also, as under the PPA level-fee rule, annual audits and extensive disclosures would be required regarding the extent to which the advisor's employer or its affiliates could potentially benefit from the selection of different investment options.

The PPA Computer Model Rule and the Class Exemption Off-Model Rule.

Under the second rule enacted in the PPA, a financial institution may design its own computer model to provide investment advice to participants even if such financial institution may benefit based on the investment options chosen. This is different from SunAmerica where the computer model must be developed by an independent third party. However, under the PPA computer model, an independent third-party expert must certify that the financial institution's computer model is valid and unbiased. The PPA computer model also includes a number of requirements not applicable to SunAmerica, such as (1) an annual audit by an independent expert (in lieu of control of the application of the model by an independent expert), (2) a requirement that the computer model take into account all investment options under the plan, and (3) a rule limiting its application to non-managed accounts. The PPA computer model is also subject to the extensive disclosure requirements referenced above, so that participants understand the potential benefits derived by the developer of the computer model.

The 2009 class exemption takes the computer model rules a step further. Under the 2009 class exemption, the financial institution that developed the computer model may also provide advice separate from the computer model, as long as the basis for that advice is explained to the participant and the extensive disclosures referenced above are provided. The rationale for the "class exemption off-model rule" is as follows. If a participant receives (1) the computer model recommendations as a reference point, (2) an explanation of the basis for the different advice, and (3) disclosures explaining how the advisor may benefit from the different advice, the participant has the tools to evaluate the merits of the different advice.

To our knowledge, there has been little use of the PPA computer model rule (and, of course, no use of the 2009 class exemption since it is not yet effective). The PPA computer model, with its extensive requirements, including annual audits, is much more expensive to administer than SunAmerica.

House Education and Labor Committee Bill.

The House Education and Labor Committee recently passed a bill that is structured as follows. First, the bill repeals the PPA investment advice provision with respect to ERISA plans (but not with respect to IRAs or non-ERISA plans). But the bill then goes further. The bill provides new rules under which there are only two permitted methods of providing investment advice to participants <u>or to a plan</u>. (As discussed further below, advice to a plan was not addressed by the PPA provisions or by SunAmerica.)

Generally, under the first method, the advice provider (1) must be registered as an investment adviser under the Investment Advisers Act of 1940, (2) must not be the "plan investment provider", (3) must satisfy the <u>pre-PPA</u> level fee rule, (4) must be a fiduciary with respect to the plan, and (5) must satisfy other requirements, including disclosure of potential indirect benefits related to the advice ("bill level-fee plus rule"). The definition of a "plan investment provider" is not clear. The definition can be read to include any financial institution that creates or manages any investment product in which <u>any</u> defined contribution plan invests, which would generally preclude use of this method by the vast majority of financial institutions. The definition can also be read to only include a financial institution that creates or manages any investment product in which the defined contribution plan receiving the advice invests. Even this narrower reading would invalidate many non-conflicted arrangements satisfying the pre-PPA level-fee rule or the SunAmerica Advisory Opinion.

The second method is very similar to the PPA computer model method, except that it adds additional requirements as a condition of using such approach ("bill computer model rule").

The bill would have some unfortunate effects, as discussed in more detail below. The Education and Labor Committee set out with important goals: to improve the quality of investment advice and to eliminate conflicted advice that is potentially harmful. However, in doing so, it appears that the Education and Labor Committee bill may have gone further than necessary to achieve its original intended objective.

Repeal of the PPA rule. With respect to ERISA plans, the bill would repeal the PPA investment advice provision (i.e., both the PPA level-fee rule and the PPA computer model rule). Even though technically the bill only repeals the ERISA part of the PPA provision, the effect is generally the same as full repeal. Although the PPA provision would remain in the Internal Revenue Code, an ERISA plan must satisfy both the Code and ERISA, so the absence of an ERISA exemption renders the Code exemption ineffective for ERISA plans.

Elimination of most SunAmerica arrangements. As currently structured, SunAmerica arrangements generally do not satisfy the PPA computer model rules, which were designed to address advice developed by entities also offering investment products in the plan. For example, SunAmerica arrangements do not have annual audits (since the advice is implemented by an independent expert) and do not need to be certified by an independent expert (since the advice is developed by an independent expert). Also, SunAmerica arrangements sometimes only take into account a subset of plan options (though this is only permitted if the independent expert confirms that it can render appropriate advice with that subset), and do not need to satisfy several of the other extensive PPA computer model rules. To comply with the PPA computer model rules would be quite expensive, an expense that plan sponsors have indicated to us that they would be very unlikely to incur. More importantly, since SunAmerica provides non-conflicted advice developed by an independent third party, the extra expense is not justified by any corresponding benefit to employees. Given the recent market upheaval, now is especially not the time to unnecessarily restrict independent investment advice.

Some SunAmerica arrangements can be redesigned to use the bill level-fee plus rule. The developer of the computer model could contract directly with the plan and accept fiduciary status. As so restructured, those arrangements can satisfy the bill level-fee plus rule. However, it is our understanding that in most cases, the developer of the computer model will not contract directly with the plan without significant additional compensation. Also, in some cases, the developer may simply not be structured to take on fiduciary duties and liabilities, or to perform the administrative tasks involved in directly implementing a managed account or advice arrangement. So the financial institution offering plan investment options is the fiduciary, and as such, contracts with the developer of the computer model. Those arrangements, which were clearly permissible under pre-PPA law and do not involve conflicted advice, would not satisfy either the bill level-fee plus rule (because the financial institution provides investment products to the plan) or the bill computer model rule (unless significant and costly changes are made) and thus would be invalidated.

Elimination of most managed accounts. Many in the advice industry believe that the most effective means of providing advice is through managed accounts, whereby advice is automatically implemented pursuant to a participant's prior authorization. Most managed accounts are based on SunAmerica.

There is some technical lack of clarity with respect to whether the bill applies to managed accounts. However, many believe that it does, and some understand that that was the Education and Labor Committee's intent. If the bill does apply to managed accounts, it would prohibit all managed accounts unless the developer of the computer model satisfies the bill level-fee plus rule by (1) accepting fiduciary status, (2) not providing investment products, and (3) receiving no compensation from firms that provide investment products. Moreover, an inability to offer such managed accounts with a subset of available plan investment options would eliminate such investment advice for a significant number of plans where incorporation of all investment options is not practicable. As referenced above, managed accounts (or advice) with respect to a subset of investment options should be permitted as long as the subset is broad enough to ensure that appropriate advice can be given, as is required under SunAmerica.

Elimination of many pre-PPA level-fee arrangements. The bill would invalidate many arrangements where the advice satisfies the pre-PPA level-fee rule. In other words, the bill would invalidate many arrangements under which the investment options chosen cannot affect the compensation of the advisor, the advisor's employer, or any affiliate of that employer. How many such arrangements would be invalidated would depend on how the definition of plan investment adviser is interpreted. But in any case, many such arrangements would be invalidated.

Elimination of all (or substantially all) class and individual exemptions. All (or substantially all) existing DOL class and individual exemptions with respect to investment advice would be repealed since they would not fit within the bill's two rules. This is of significant concern since many existing arrangements across the country rely on these exemptions. And these exemptions were the subject of rigorous scrutiny by the DOL under its demanding exemption process.

Moreover, the DOL's authority to grant any future class or individual exemptions with respect to investment advice would appear to be effectively repealed. This would remove a major source of flexibility needed to ensure that advice services for plan participants keep pace with developments in the marketplace.

Elimination of most plan-level advice. The PPA provision was limited to advice provided to participants. However, the bill goes further and very significantly limits advice that may be given to a plan. For example, in certain situations, an advisor may be asked to provide advice to a plan sponsor (especially small businesses) regarding which investment options should be offered to participants.

Guidance regarding which investment options should be offered to participants cannot be given through a computer program, so under the bill, investment advice to a plan can only be given under the bill level-fee plus rule. If the plan investment provider definition is read expansively to preclude the use of the bill level-fee plus rule by a financial institution providing financial products to any plan in the country, virtually all financial institutions would be precluded from providing advice to a plan, regardless of whether such advice is conflicted.

The area of advice to plans is not one that has been the subject of almost any public policy debate, either during consideration of the PPA or now. In the absence of any discussion, the bill's very significant restrictions on non-conflicted advice to plans are of concern.

<u>Elimination of many sources of non-conflicted advice.</u> The bill would prohibit many regulated entities, such as banks, from providing non-conflicted, non-computer model advice, even if the entity would otherwise satisfy the pre-PPA level fee rule and the bill level-fee plus rule. This prohibition would apply because the entity is not registered as an investment adviser under Investment Advisers Act of 1940, but is regulated under a different set of rules.

<u>Public Policy.</u>

The Education and Labor Committee set out to improve investment advice, but the bill went much further and would invalidate the majority of existing advice arrangements regardless of whether such arrangements involve potentially harmful conflicts of interest. This would have a huge adverse effect on participants. Employers are not required to offer investment advice programs and, in this economic climate, there are few employers able to absorb new costs and burdens attributable to a purely voluntary program that is currently working well to provide helpful, non-conflicted advice. Accordingly, informal indications from plan sponsors are that the imposition of new costs and burdens would result in the termination of these critically important, non-conflicted advice arrangements, not expensive redesigns. At the same time, employees need advice with appropriate safeguards now more than ever; we should be encouraging not discouraging such programs.

The impetus for the Education and Labor Committee's actions appears to have been the PPA investment advice provision and the 2009 class exemption. In this context, the public policy debate should be focused on the PPA provision and the 2009 class exemption. The goal of the PPA investment advice provision was worthy and is one that we share: to broaden the availability of investment advice to participants very much in need of advice. Moreover, we urge Congress and this Committee to carefully consider any action that would reduce the availability of investment advice to participants. However, if Congress determines that the PPA provisions and the class exemption provide insufficient protection against conflicts of interest, an appropriate response would be to address those issues directly. But there is no reason to do more than that.

To summarize, the following should be preserved, not prohibited:

- SunAmerica advice, which is based on a computer model developed by an independent third party and thus is clearly not conflicted.

- Advice satisfying the pre-PPA level-fee rule, which is by definition non-conflicted.

- Non-conflicted managed accounts (either under SunAmerica or the pre-PPA level-fee rule), which should be promoted as an effective means of providing advice.

- DOL class and individual exemptions. If DOL would like to reexamine any class or individual exemption, it has the power to do so. Invalidation of all such exemptions without careful review is not appropriate.

- Non-conflicted advice to a plan, which was not addressed by the PPA or the 2009 class exemption, and should not be limited today.

- Advice provided by qualified entities that are not registered investment advisers but are selected by plan fiduciaries after the type of careful fiduciary review required by ERISA.