TESTIMONY OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

ON PROPOSED AMENDMENTS TO REGULATIONS UNDER ERISA SECTION 408(b)(2)

PRESENTED BY
WILLIAM. E. RYAN III

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Good Morning. My name is Bill Ryan, and on behalf of SIFMA, I appreciate the opportunity to testify before you today. As you know, SIFMA is the product of a merger of the Securities Industry Association ("SIA") and the Bond Market Association with more than 650 securities firms, banks and asset managers. We particularly appreciate the Department's responsiveness to our request that the Department hold a hearing on this very important proposal. We hope our comments thus far have been helpful and constructive and we stand ready to answer questions or provide additional information to assist the Department in any way we can.

Our testimony today will focus on four points:

I. First, SIFMA respectfully submits that the Department's objective – enhanced disclosure requirements of fees -- should be addressed by the issuance of guidance under the fiduciary responsibility provisions of ERISA section 404, not the prohibited transaction provisions of ERISA section 408(b)(2). As we understand it, the Department's chief concern is the receipt of payments from third parties (such as mutual funds, advisors, transfer agents or the like) by pension consultants, brokers, advisors or recordkeepers that plan fiduciaries should be better aware of, and we are fully prepared to work with the Department to ensure that these payments are disclosed.

II. Second, in achieving its objective of enhanced disclosure, the Department should not mandate specific disclosure of what is required of every service provider, regardless of the types of service providers involved. SIFMA urges the Department to recognize that "one size does not fit all," and allow a plan fiduciary to hire service providers who are paid from plan assets without these overly specific rules that could become outdated, depending on how the plans and market evolve.

III. Third, in its efforts to expand disclosure to plan fiduciaries, SIFMA is concerned that the Department has inadvertently over-extended its reach through the use of ERISA section 408(b)(2) as the vehicle for the changes. Brokerage commissions or advisory fees paid from the assets of a nonplan asset vehicle are not covered by the prohibited transaction provisions. At a minimum, any final regulation should distinguish between compensation paid by funds and their affiliates for distribution, recordkeeping, and similar services in connection with the plan that purchased the mutual fund shares, on the one hand, and commissions paid for the purchase of the underlying portfolio securities within the nonplan asset vehicle, on the other.

IV. Finally, SIFMA believes that the effective date of the final rule needs to, at a minimum, coordinate with the effective date of Form 5500 reporting (July 2010). Only by that date will service providers have appropriately digested the rules, determined what will need to be changed about their disclosure, and communicated the necessary information to plan fiduciaries

<u>Enhanced Disclosure and ERISA section 404</u>

SIFMA strongly supports the goal of ensuring that plan fiduciaries have the information they need to ensure that compensation received by service providers is reasonable. We continue to believe, however, that the fiduciary requirements of section 404 of ERISA are more amenable to a flexible approach to disclosure than is evidenced in the proposed regulation. Rather than a one size fits all approach, which is cumbersome and untargeted to the particular kind of service provider, we believe that the approach of the current framework – allowing a fiduciary to decide how much disclosure is appropriate under the circumstances, and how to obtain that disclosure efficiently – should not be discarded in the legitimate effort to raise the consciousness of plan

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fiduciaries regarding the information that may be relevant to their decisions. Current exemptions rely on the appropriate plan fiduciary, assuming a minimum level of sophistication, to make decisions regarding plan services and transactions without dictating the rules by which governing this decision-making. Surely a fiduciary could appropriately apply a different standard in obtaining services from FedEx as opposed to investment management services, yet both are held to the same level of conflict disclosure, with the same excise tax penalties applicable for any inadvertent foot-fault on disclosure. We urge the Department to recognize this reality and to retain the flexibility of the existing regulation.

We are pleased that a signed document between a plan fiduciary and the service provider is not required and we urge the Department not to abandon this approach. Some brokerage arrangements are documented between the bundled service provider and the plan sponsor, and not directly with the clearing brokers hired by the service provider. Outside of the individual account plan context, the written arrangement – say between the investment manager and the brokers they hire, is documented through the disclosure required under the securities laws. Even where agreements exist, however, the cost of redocumenting every arrangement and the delays inherent in obtaining the necessary signatures, as well as the consequences if plan fiduciaries do not promptly sign their agreements, will have a very adverse effect on plan transactions. We also applaud the Department's recognition that it would be onerous and expensive to require that all disclosure be in one document provided to each client at a particular time in a specified manner. Permitting service providers to incorporate by reference other documents such

as the Form ADV, Statement of Additional Information (SAI), etc. will help decrease the burden and cost of complying with the new regulation.

SIFMA would be pleased to work with the Department on any plan fiduciary education website or other seminar that will inform the plans of the importance of the information disclosed in these documents. We strongly believe that the Department's approach on the disclosure documentation issue is the correct one and we urge the Department to retain that formulation in the final regulation.

Content and Specificity of Fee and Service Disclosure Needs to Be Flexible

We also urge the Department to take a flexible approach to the timing, of, as well as the specificity of the disclosure required for compensation and services, performed by service providers.

In many industries, such as securities brokerage, the Securities and Exchange Commission has historically administered a disclosure framework that ensures that the most meaningful information is provided with the trade confirmation. In the brokerage industry, the executing broker provides disclosure in the form of a confirmation after the transaction is effected, containing information about the transaction itself (such as the date, time, identity, price and number of shares involved), about its capacity (i.e. whether it is acting as an agent or a principal); its compensation (for agency trades, compensation includes its commission); the source and amount of any remuneration received or to be received from a third party by the broker in connection with the transaction; whether any odd-lot differential (or equivalent fee) has been paid in connection with the execution of an order; and specified information in the case of any transaction in a debt security. This disclosure is not provided in writing in advance (and it would be entirely impractical to

do, since so much of the transaction disclosure depends on facts not known in advance) and it may not always be provided on a plan-by-plan basis to the investment managers that utilize the broker's services on behalf of the manager's various accounts (pooled and otherwise).

We also urge the Department to permit current disclosure and agreement practices in the securities brokerage industry (many of which are mandated by SEC, FINRA and various state laws) to continue, without the costly and burdensome requirements that would be imposed for ERISA accounts only by the proposed rule. Operationally, most of our members have systems through which disclosures are mailed centrally from the home office automatically upon account opening or sent after trade execution. One of the benefits of this centralization is that the firm, rather than an individual, controls the delivery of the disclosures to ensure consistent compliance with the delivery requirements under securities laws. In this connection, we urge the Department to consider a safe harbor for disclosure under the regulation, such that any disclosure that meets the requirements of the securities laws will be deemed to meet the disclosure requirements of Section 408(b)(2). Finally, we urge the Department to consider a rule similar to that in the insurance company general account regulation, 29 CFR 2550.401c-1(i)(5), which allows noncompliance to be cured in a reasonable period of time. We believe the regulation should provide that if a service is provided that has not been disclosed, its full disclosure within a reasonable period after discovery, should regain the protection of Section 408(b)(2).

Further, we hope the Department will clarify that for brokerage services, providing a comprehensive written disclosure document in advance will not be required for a number of additional reasons:

First, all of the services which may be provided to a particular client may not be known in advance of the relationship,

Second, all of the relationships that may apply to a particular plan relationship with a service provider cannot be known in advance of the relationship, since the conflicts will change over time depending upon the services the clients select, the client's investment decisions and corporate changes at both the service provider and at the client level; and

Third, every form and amount of compensation will be impossible to determine in advance of the relationship as these too are dependent upon the services and investments the plan selects over time.

One document, in advance, cannot address all of these variables with any level of intelligibility.

We also hope that the Department will provide additional clarification on the level of specificity in regard to the disclosure of fees and compensation as well. Brokerage commissions illustrate how it can be difficult (and in some cases impossible) for a service provider to determine the exact dollar amount of indirect compensation. As you know, services and fees may not be provided or allocated on a plan by plan basis so it may not be possible to report or allocate amounts on that basis. Indeed, many broker-dealers are not aware that the account for which they are trading is owned by a particular plan. This difficulty was acknowledged in the Final Rule and Notice regarding the Annual

Reporting and Disclosure Revision of Annual Information Return/Reports which allows for the description of a formula used to calculate or determine the compensation rather than the exact amount of compensation for certain service providers. We urge the Department to provide flexibility that would permit the plan fiduciary to request an estimate or rely on the disclosure available in trade confirmations.

This is a particular problem in the institutional brokerage area, but requires clarification in the area of retail brokers as well. For example, we urge the Department to allow a retail broker acting as a consultant to a 401(k) plan to inform the plan fiduciary that different mutual fund families pay different fees to the broker, and within a fund, different share classes pay different levels of such fees to the broker as disclosed in the fund prospectuses, without having to specifically disclose the rates for all share classes of all funds that the plan fiduciary could ever select. Once the plan fiduciary has the applicable fee rates, and the level of assets in each fund (which is readily available from his custodian), he or she can estimate the fees received by the broker. In our view, that is significant and helpful additional disclosure which will not overwhelm the plan fiduciary but will allow him to understand what his consultants may receive.

A related issue is the level of specificity relating to the description of services. It is possible that an ancillary service not contemplated in a service contract is provided by a service provider. Any ancillary service will likely be provided free of charge because, in most cases, the amount the plan is paying the service provider for the service will remain the same. It is also possible, in fact likely, that the specific services themselves are subject to diverse descriptions by different vendors – for example, we are hard-pressed to clearly articulate all of the various forms of "recordkeeping" that a plan may

require at the participant, investment or trust level. For example, a recordkeeper may include in its services the reconciliation of trades but may not charge separately for that service and may not list it as part of the services since in most recordkeepers' viewpoints, reconciliation is part and parcel of recordkeeping.

Moreover, if the particular service is covered by a single fee there is simply no need to unbundle that fee to describe all of its components. For example, a broker may charge a plan 5 cents a share. That commission includes exchange fees, the cost of confirming, the cost of clearing and settling, and any access charges if the trade is executed on an electronic communication network. There is simply no utility in having a plan receive disclosure that goes into that amount of detail. In addition, there may be charges that no one would expect to be incurred, (such as ACAT fees, section 31 fees, inactivity fees, legal transfers, accommodation transfers, extensions, returned items, statement copies, overnight/express mail, trade corrections, confirm copies, and foreign securities transfers) that would not be anticipated for every trade. Where a broker has a fee schedule available on request, and makes its availability known to the plan fiduciary, we believe the rule should be satisfied and such charges should not need to be disclosed in advance, so long as they were disclosed promptly after they were incurred. In addition, we believe there are certain payments or concessions that an executing broker may receive that are not on account of a particular plan or particular trade (such as payment for order flow, discounts on fees associated with ECNs or trading venues, moderate entertainment, conferences and meetings). We strongly believe that the proposed rule, like the instructions to the Form 5500, should state that if payments are received that are not allocable to a particular plan but paid because of an entire

relationship, they need not be disclosed as compensation within the meaning of this regulation.

The proposed rule provides that a contract or arrangement must require that the service provider disclose specific information regarding conflicts of interest for the service provider in its performance of services for the plan. Service providers generally will have to disclose any financial or other interest in transactions in which the plan will participate; describe material financial, referral, or other relationship it has with various parties that creates or may create a conflict of interest for the service provider pursuant to the contract or arrangement; and identify whether a service provider can affect its own compensation from whatever source without prior approval of an independent plan fiduciary. The proposed rule is so broad that it will be virtually impossible for some of the larger financial service providers to enumerate every single existing or potential conflict of interest (which is currently not required even under the Advisers Act for investment advisers, which focuses on "material" conflicts). We believe it is vital that the Department provide a solution for larger service providers whose services permeate the industry and for whom almost every contract or arrangement gives rise to existing or potential conflicts of interest.

If the industry is required to document in advance every possible service, or fee that a broker may be asked to perform, or all potential conflicts, the disclosure will be so voluminous that many plan fiduciaries will not read it at all, and it will defeat the entire purpose of the Department's initiative. But, as we know you appreciate, the potential for an excise tax will make the writers of the disclosure insist on extraordinary detail, to

guard against any item being inadvertently omitted. We hope you will agree that this approach will help no one.

Application of ERISA Section 408(b)(2) to Non- ERISA "Service Providers"

The proposal applies to three categories of services providers. The first category includes "service providers who provide services as a fiduciary under ERISA or under the Investment Advisers Act of 1940 ("Advisers Act")." It is unclear what service providers the Department intends to capture by referencing fiduciaries under the Advisers Act (a term that, as a technical matter, is not defined under the Advisers Act at all, but which refers simply to the roles and responsibilities of an "investment adviser"). It may be that the Department is intending, through this language, to suggest that an adviser to a mutual fund, because it is an adviser under the Advisers Act, is a service provider to an ERISA plan that purchases a share of that mutual fund. As noted elsewhere in these comments, we strongly disagree with the notion that an adviser to a vehicle which does not hold plan assets is subject to section 406 of ERISA and requires the relief provided under section 408(b)(2). If the Department believes that this language will require mutual fund advisers to enter into service arrangements with ERISA plans that meet the disclosure requirements of the proposed rule, we disagree with that conclusion and suggest it has no legal basis under ERISA or the Department's own regulations. We think this reference is overbroad, and will sweep in individuals who, under the long-established definition of fiduciary under ERISA, are simply not fiduciaries under this statute. We are concerned that this language effectively amends 29 CFR 2510.3-21 to include, in the definition of fiduciary under ERISA, any individual who is a fiduciary under the Advisers Act. This departure from settled law will confuse plan fiduciaries and

service providers alike, and will distort the definition of fiduciary far beyond the limits that Congress contemplated.

For example, there are scenarios in which a specific service provider may be subject to fiduciary standards in the Advisers Act under one set of circumstances, but not under another by virtue of the types of services the adviser is providing. For example, a dual registrant – a registered broker dealer who is also registered as an investment adviser under the Advisers Act – may act exclusively as a broker for a plan and therefore not be governed by the Advisers Act in the performance of those duties. As the Department surely understands, the determination that an individual is a fiduciary under ERISA depends on whether he or she meets the statutory requirements for discretionary management and control, or the provision of investment advice for a fee on a regular basis where both parties mutually understand that the advice is intended as a primary basis for the plan fiduciary's decisions. That, as described above, is decidedly not the definition of fiduciary under the Advisers Act. We urge the Department to delete this troubling reference to a statute outside its jurisdiction.

In addition, the reference to fiduciary under the Advisers Act suggests that even investment advisers who are not be subject to fiduciary requirements under ERISA will be required to make the proposed disclosures. For example, we question whether the Department, under certain circumstances, intends to circumvent the plan asset rule by treating persons with investment management responsibility over assets that are not "plan assets" like ERISA fiduciaries, even though they are not. Specifically, a fund or vehicle without plan assets managed by an investment manager providing investment advisory services to a fund or vehicle does not have a contract or arrangement with the plan and

will not be compensated directly by the plan. Under the Advisers Act, the investment manager in such cases owes its fiduciary duty to the asset vehicle as a whole and has no duty to individual customers, as distinct from cases where the manager is providing service to plans via plan asset vehicles. We believe that the Department could not intend to ignore its own plan asset regulations in suggesting that the performance and management fees a manager of a non-plan asset vehicle receives may be considered indirect compensation paid by a third party (the fund or vehicle) under the proposed rule and somehow subject to Section 408(b)(2). However, our concern is heightened because of the reference to the receipt of fees in connection with the services provided "**or the financial products in which plan assets are invested".** Despite the fact that there has been much debate about the meaning of these words, we have concluded that they can only do mischief. A person providing services to an entity that is not a plan and that does not "hold plan assets" under the Department's regulations is not a service provider under ERISA solely on account of those services. Such a person neither needs relief from the prohibited transaction provisions of ERISA nor the protection of this regulation.

Congress intended that parties in interest to plans would be able to identify themselves by reference to a clear list of persons described in Section 3(14). While Congress intended the definition of fiduciary to be a functional test, it did not intend that a broker dealer purchasing or selling mutual fund portfolio securities be considered a party in interest under ERISA by means of being a service provider to a plan, simply because a plan owned a publicly traded share of that mutual fund. Such a rule would be difficult to comply with, since brokers generally do not have access to the identity of mutual fund shareholders. Indeed, the statute clearly authorizes a mutual fund to

represent that when a broker deals with the mutual fund, it is not dealing with plan assets. Similarly, the mutual fund itself does not necessarily know whether its shares are held by plans, especially where the purchases are made through omnibus accounts.

The Department has recognized that not all entities that provide services are providing those services to plans. In many cases, those services are provided to another service provider. So for example, an executing broker may hire a different broker to clear and settle trades and always hires a depository to custody securities on an electronic basis. Prime brokers hire foreign local subcustodians, who are effectively providing services to the prime broker to enable him to do his job worldwide. The printer and mailing service provides services to the recordkeeper; so, for that matter, does the U.S. Postal Service, Federal Express, UPS and other delivery services. They may be part of plan services but they are providing those services to the recordkeeper who has undertaken to communicate with plans, with mutual funds, with the IRS, with the bank custodian. We believe that it is important for the Department to distinguish between entities that provide services to plans, and entities that provide services to other service providers. Under current law, it is not critical to make this distinction because even if one were to consider the U.S. Postal Service to be a plan service provider, the U.S. Postal Service could rest easy, knowing its services were appropriate and necessary, reasonably priced, and terminable on short notice. However, under the proposed rule, it makes an enormous difference whether the entity is a service provider to plans, or only to other service providers. We urge the Department to make clear that where an entity has no independent contact with a plan, its services performed for other service providers does not make them parties in interest to plans, and does not subject them to Title I of ERISA.

In addition, we hope the Department will make clear that pursuant to the disclosure requirements, a service provider is not required to list all services, all compensation and all conflicts of any "agents" of the service provider.

Related Compliance Challenges

We also would like the Department to reconsider the 30-day period for advising plan fiduciaries of changes. As we have explained in other contexts, 30 days is a very short time to notify hundreds, if not thousands of plan fiduciaries. We strongly urge the Department to increase this time period to 90 days, or the end of the quarter following the quarter in which the change occurs.

The proposed regulation provides a special rule for bundled services that are priced as a package. The rule permits the disclosing service provider to report compensation on an aggregate basis, which is very helpful. However, it then goes on to say that fees must be separately reported "to the extent such party receives or may receive compensation or fees that are a separate charge directly against the plan's investment or that are set on a transaction basis, such as finders fees, brokerage commissions, and soft dollars". We are concerned that this exception may swallow the rule. For example, consider where a plan enters into a wrap program, paying one fee to cover asset allocation by the wrap provider, asset management by affiliated and unaffiliated managers, and all brokerage through the wrap provider's affiliate. Since the entire fee is a charge against the plan's investment, all of the fee components would have to be disclosed separately. We urge the Department to revise the exception to permit the service provider to provide such other reasonable information as the plan fiduciary may request about the components of the bundled fee.

We also strongly urge the Department to leave other exemptive relief unaffected by these new rules under Section 408(b)(2). We believe it is entirely appropriate for any applicable prohibited transactions exemption to continue to apply notwithstanding the exemption in Section 408(b)(2).

We believe that the proposed rule needs some fine tuning with respect to the advance disclosure of gifts, entertainment, conferences, meetings and the like. Such items are obviously not disclosable with any kind of specificity in advance. We urge the Department to change the proposal in this regard in three ways. The first is to allow service providers to generally disclose the kinds of gifts, entertainment, conferences, meetings and the like that they might receive. The second is to provide that with respect to any gifts, entertainment, conferences, meetings and the like that a service provider actually receives, disclosure is given at that point to the plan fiduciary, subject to the following exception, which is our third point. The regulation should specifically provide that (i) where gifts, entertainment, conferences, meetings and the like are received by the service provider because of an overall relationship with the giver, and not directly because of the plan, no disclosure need be made; and (ii) even where the gifts, entertainment, conferences, meetings and the like are received directly because of the plan, if the amounts do not exceed the de minimis rule in the Form 5500 instructions, no notice need be given.

Effective Date

Finally, regardless of the changes between the proposed regulation and the final rule, we are sure that the Department appreciates that a wide range of service contracts with ERISA-governed plans will be affected. Under the proposed revisions, the changes

will become effective 90 days after publication of the final regulation, which is a very short time frame to bring a very broad range of contracts into compliance. It will be impossible, especially in light of the potentially extensive clarification required in the final rule, for service providers to evaluate and revise their existing and prospective service contracts and arrangements, and implement entirely new systems and procedures to track the disclosures required by the proposed rule. We strongly urge the Department to postpone the effective date of any such changes until a date at least eighteen months from the final publication date, so that service providers can properly digest clarifications the Department makes and prepare for the implementation of the final rule. Where the consequences for failure are so high, and the amount of disclosure so voluminous, in the context of financial institutions that are in so many different lines of business, all of which could require significant conflict disclosure, it is impossibly burdensome to provide only a few weeks to fully comply with the new rule. We think this very short effective date period is particularly troublesome when, with respect to the Form 5500, the Department so appropriately recognized that compliance with these rules would take over a year and provided nearly 14 months as a transition period. Furthermore, existing relationships should be grandfathered. While we understand the Department's concern over the potential to abuse a grandfather provision, many arrangements span several years or have no specific term (for example, those terminable on thirty days notice). Rather than providing no relief, we urge the Department to adopt a grandfather rule for arrangements already in existence until they are formally extended, renewed or materially modified. When Congress enacted ERISA, it provided a transition period of two and a half years to bring service contracts into compliance with the Act (see Section 414(c)(4)).

We believe that the scope of necessary changes required by the proposed rule is at least as extensive, if not more extensive, then when Section 408(b)(2) was enacted. We have no doubt that the Department wants this communication to be careful and thorough. With that in mind, we urge the Department to give service providers the time to do it correctly.

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Thank you allowing us to present our views at this hearing. We appreciate your willingness to work with plan sponsors and plan service providers on this important regulation.