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on behalf of

The Securities Industry and Financial Markets Association

Before

The Committee on Ways and Means

Hearing on Defined Benefit Pension Plan Funding Levels and Investment Advice Rules

United States House of Representatives

October 1, 2009

Good Morning, Chairman Rangel, Ranking Member Camp, and Members of the Committee. I am Jim McCarthy, Managing Director, Retirement Services, of Morgan Stanley Smith Barney and I am testifying on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1]. SIFMA's member firms are engaged in every aspect of the retirement plan industry, including retirement plan creation, investment management, recordkeeping, and advice and education. Morgan Stanley is a global financial services firm, providing brokerage, custodial and investment-related services to approximately 3.4 million retirement plan accounts and approximately $370 billion in assets and 5 million individuals who we are helping plan for their retirement. Like many brokerage firms, Morgan Stanley Smith Barney advisors are actively engaged in helping plan sponsors select and monitor retirement plans as well as assist our individual clients with their savings and investment concerns.

We appreciate the opportunity to testify today on investment advice for retirement savings, on H.R. 2989 which would repeal the Pension Protection Act's (PPA) exemption for investment advice and prior DOL guidance, and the negative effect this change would have on the actual delivery of specific, focused investment advice for retirement clients. Prior to the enactment of the PPA, policymakers consistently cited the need for more professional advice for participants with respect to their retirement savings. There is an even greater need for such advice today, in light of the volatility and precipitous drop and then rise in the markets. Only a small percentage of American workers have the benefit

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

of professional investment advice from individuals who hold themselves out to be fiduciaries and subject themselves to ERISA's fiduciary requirements. Current market conditions have affected retirement security and employees' confidence in their financial ability to retire. Our member firms hear everyday that benefit plan clients would like additional advice and support on retirement planning, investment allocation and strategies for these assets. Without additional professional advice in the market place, this situation will not change. Our members are very concerned that H.R. 2989 will have unintended, and harmful consequences. First, it will drastically reduce, not increase, the number of advisors available to provide this professional advice. Second, in contrast to the PPA, which put the burden of compliance with the exemption on the investment advice providers, it will force plan sponsors to take on additional fiduciary liability. Rather than making advice available to their employees, plan sponsors will choose not to provide advice programs at all. Respectfully, we believe that H.R. 2989 is a radical solution to the wrong problem – eliminating the appearance of conflicts, at the expense of giving workers the advice that they need.

American workers' retirement savings are increasingly held in participant-directed accounts such as 401(k) plans and in IRAs, either by contribution or through rollovers from employer sponsored retirement plans. Today, about 63 percent of the full time workforce is covered by a 401(k) plan; over the next 10 years, a high percentage of these assets will be rolled over into IRAs. IRA assets totaled $4.13 trillion as of September 30, 2008 – they already exceed assets in defined contribution plans, and are expected to increase further as workers retire in greater numbers and roll over their 401(k) balances. As a larger and larger percentage of these savings accumulate in IRAs which may be invested in the entire range of investment products -- annuities, stocks, bonds, foreign investments, mutual funds and other pooled vehicles -- investment advice on what vehicles/investments will be appropriate for an individual's particular circumstances is even more critical to help retirees through this wide array of investment choices.

ERISA and the Internal Revenue Code, which are the primary rules governing private retirement accounts, define every person who provides services to a plan as a so-called party in interest. As parties in interest, service providers are prohibited from engaging in any transaction or providing any service to a plan or an IRA unless the terms of an exemption are met. The prohibited transaction provisions of ERISA and the Internal Revenue Code (1) make all service relationships "conflicted" to a plan or IRA and (2) require that the conflicts be managed either through a statutory exemption, or through a class or individual administrative exemption which the DOL determines to be in the best interests of plan participants and beneficiaries, and protective of their interests.

Prior to the PPA, the exemptions available to fiduciary service providers were limited to a single investment product, such as bank deposits, or mutual funds, or annuities. There was no single exemption that would allow investment advisory services to be provided by someone whose affiliates might be selling multiple investment products, like securities, or mutual funds, or insurance contracts, or bank investment products, to a plan or an IRA – the only way that such a situation could work to avoid any conflict was that the advisor recommended none of its affiliates' products. In 1975, Congress thought such a restriction was unrealistic, and did not prohibit the DOL from trying to come up with rules to govern these situations, but no comprehensive solution emerged. In 2006, Congress found that the absence of a comprehensive investment advice exemption, either from DOL or from prior legislative initiatives, was largely responsible for the fact that few broad investment advice programs were offered by banks, insurance companies and broker-dealers. Instead, what was offered prior to the PPA was a patchwork of exemptions permitting a fiduciary to provide advice on one or another product type and then sell that product. Each such exemption contains different requirements and each covers only one type of product. These exemptions often do not contemplate the various compensation arrangements in existence today, nor do they cover all of the investment products that 401(k) and IRA holders can invest in. In addition, this approach discourages the introduction of innovative products designed to address longevity, inflation and market risks.

Congress concluded that what was needed in 2006 was a comprehensive exemption that clearly lays out the requirements for advisors to provide advice to plan participants, regardless of what types of investments are being recommended. The PPA addressed that need. It created a system intended to deal with conflicts, not to run away from them. It placed the responsibility for complying with the exemption on the advisors who seek to use the exemption, not on plan sponsors who understandably do not want to take on the risk of continuous monitoring of each and every condition of the exemptions. It gave the Department the authority to interpret and expand on the statutory exemption, using the judgment and experience it has acquired in dealing with these conflict issues since ERISA's enactment. It moved away from an inflexible and participant unfriendly set of rules and toward a realistic method of actually delivering in person advice to participants.

The statutory changes authorized in 2006 directed the Department to issue a separate class exemption with respect to IRAs if it found that there are no computer models capable of taking into account the full range of investment products available to

IRAs. The DOL interpreted the mandate very narrowly and found that a handful of computer models could be utilized for IRAs.[2] However, the DOL recognized that IRA owners have access to an unlimited array of investment products and under its own authority, proposed a class exemption specifically addressing the need to provide more flexibility for IRA owners.

As the Committee evaluates H.R. 2989, we would like to emphasize the following:

<u>1. Nothing Under Current Law, Pre-PPA or Otherwise, Prevents the Hiring of Unaffiliated Advisers</u>: We are strong advocates for the current computerized advice programs provided by advice providers such as Ibbotson, Financial Engines and Guided Choice, who are not affiliated with banks, broker dealers or investment companies. Neither the PPA exemption nor the DOL class exemption is biased against unaffiliated advisers. Indeed, the Department's rules make clear that every participant must be told that he or she may receive advice from an advisor who is not affiliated with any product. This reminder serves to underscore the choices available to participants and to provide a useful alternative for those who would prefer a different course.

<u>2. H.R. 2989 Will Limit The Choices that Plan Participants/Sponsors Deserve:</u> The PPA investment advice provisions would not have been necessary if Congress thought the current delivery system for unaffiliated investment advisers -- which is largely web-based -- would, and actually did, deliver advice to a wide range of individuals. Because web-based systems can be inflexible and impersonal, the current unaffiliated advice programs do not reach enough workers in ways that are comfortable

[2] http://www.dol.gov/ebsa/publications/reporttocongress.html

for workers, to make professional investment advice the norm, rather than the exception. Many advice providers depend on the Internet for the delivery of advice; while that approach may work for some participants, in our experience, plan participants still seek and need personal interaction with a fiduciary advisor. If the rules promulgated under the PPA had been allowed to take effect, plan participants would have had access to advice providers who offer advice on a wide variety of investments – in person or on the phone – in a cost-effective manner. Participants would also be able to receive advice which takes into account all of their savings, including their nonretirement savings, their IRAs and their 401(k) plans. The current models offer no such flexibility, even though the DOL's own guidance repeatedly urges advisors and advice educators to take into account all of a participant's savings.

3. H.R. 2989 Will Substantially Reduce the Number of Participants Who Actually Receive Advice Under the Current Rules: If financial institutions cannot recommend an investment if they or their affiliate serves as a custodian, broker, record keeper, or investment provider to a plan or IRA, rather than increase coverage, roughly 20 million fewer plan participants and IRA owners will no longer have access to existing advice programs, let alone the expanded offerings that PPA was to make available.[3] The lack of advice was Congress' concern in 2006, and there has been no significant increase in fiduciary advice programs since then, in anticipation of the DOL's issuance of regulatory guidance for the PPA. The Department's regulation and class exemption would be a step closer to reaching the stated goal of the PPA's investment advice provisions. Comments received by the DOL from individual participants and

[3] The Profit Sharing/401(k) Council of America reports that 20 million participants are offered advice through Sun America arrangements.

beneficiaries make clear their need for investment advice, particularly in this economy. But to limit advice to providers who have no affiliates selling products to plans and IRAs will continue the status quo – not enough advisors, not enough professional fiduciary advice.

4. IRA Owners Need Access to Flexible Advice Solutions: The delayed DOL class exemption recognizes that, as millions of workers change jobs or move into retirement, they may seek to choose from the many different types of investment products that cannot be modeled effectively with a computer program. IRAs may invest in stocks, bonds, CDs, currency, annuities, and many other financial products. As more of the population nears retirement, employers and financial services firms are working on product innovations that it may or may not be feasible to model. Reliance on computer models that include only one kind of investment product will stifle innovation or leave middle-income families with few choices in retirement. IRA owners are increasingly interested in investments that can't be modeled, such as bank products, securities (including Treasury instruments), annuities and pooled funds. Let me give just one example: without the class exemption proposed by the Department, an advisor at a financial firm could not recommend that an IRA owner invest half his IRA in a product that provides level income for life, and the other half in a laddered Treasury bond program, because there is no model that encompasses both of these products. Nonetheless, this is certainly a program that many IRA owners might reasonably want to consider.

A computer model provider could not respond to questions from participants that go beyond the model's required inputs, such as questions about suitable levels of risk. If the results of the model were unsatisfactory, a participant's only choice would be to run the model again, trying to guess at the inputs that would allow the model to provide choices that meet his or her needs. The class exemption addresses how off-model advice can be provided with sufficient safeguards, including contemporaneous recordkeeping, advance disclosure, and audit requirements that will protect participants and beneficiaries and create a record for ensuring that the requirements of the exemption and ERISA's fiduciary responsibility provisions have been satisfied.

Finally, the PPA final rule and class exemption protect participants. Only individuals subject to oversight of insurance regulators, the SEC, or similar state agencies or banking regulators can provide advice. This adds a layer of oversight and protection to these rules that does not exist under current law, where anyone can provide advice so long as he or she follows one of the methods in the Department's existing guidance. Additional protection is found in the requirement that participants be told that they are always free to seek advice on their own from an advisor whose company does not sponsor investment products, if that is what they prefer. This information will cause all plan participants and IRA owners to focus on how much oversight, and indeed skepticism, they want to exercise with respect to their own retirement savings. Another safeguard is the requirement that if an advisor recommends an investment with higher fees, he must explain why the higher fee investment is better for the participant. The material conflicts in the advisor's advice must be fully disclosed in writing: this focused disclosure is still another protection for participants and IRA owners. A further protection is the dire consequence of failing to meet the requirements of the exemption. Not only will the transactions that failed to meet the statutory requirements have to be reversed and the client restored to the position he or she would have occupied had the investment not been made, but unlike any other exemption the Department has issued, if there is a pattern and practice of failures, all of the transactions during the period of noncompliance will lose the relief provided by the exemption and will have to be reversed, *including those that did not violate the law.*

Still another protection is the annual audit. The final regulation and class exemption require the fiduciary advisor to obtain an independent audit on an annual basis. This audit is protective of plan participants and consistent with other exemptions that the Department has granted in the past. The audit requirement is analogous to the so-called QPAM look alike exemptions and the in-house manager exemption which requires an independent annual audit based on sampling. The audit will be done by professionals; the selection of the auditor will be subject to ERISA's fiduciary standards; and the results of the audit will be made available to plan sponsors, IRA owners, and, where there is evidence of a failure to meet the exemption, to the DOL. We believe this requirement is a strong protection for participants and beneficiaries which make the exemption administrable by focusing the DOL on the situations where independent auditors found evidence of noncompliance.

The final regulations interpreting the statutory exemption and the class exemption have been subject to a thorough process of evaluation and analysis. The DOL issued a Request for Information soliciting public comment before it even began to draft regulations, held two hearings, issued a Field Assistance Bulletin with its views in early 2007, and published a proposed and final regulation and class exemption, as well as a request for comments after the regulation and class exemption had been published in final form. All stakeholders have been heard. While some may disagree with the investment advice exemption in the statute, or with Congress' mandate to the DOL to determine whether models exist that can appropriately model any investment in which an IRA may invest, the final regulation and class exemption are both true to the statute and the class exemption contains the statutory findings necessary for the DOL to exercise its administrative discretion to promulgate relief. This process has been careful, thoughtful, and designed to elicit the views of the entire benefits community.

The final exemption is clear, protective and administrable. Its disclosure requirements are based on sound public policy guidance, and are more extensive than the basic ERISA exemptions that have been in place for more than 20 years, including PTE 77-4 for a fiduciary's use of its affiliated mutual funds, and PTE 86-128 for a fiduciary's use of its affiliated broker-dealer. In addition, unlike these earlier exemptions, the advice exemption provides an audit to the plan participant (similar to certain individual exemptions granted by the Department in recent years), and has a far more dire consequence for a pattern of noncompliance. Thus, the advice exemption, by analogy, has been proved to be administrable over time. But what is most important, these rules will, for the first time, present the realistic chance that widespread, easily accessible, person to person based professional fiduciary advice will be available and used by tens of millions of plan participants and IRA owners. We urge you not to lose sight of this goal. If professional fiduciary advice is to become the norm, we need to encourage those that are capable, trained and regulated to step forward and give this advice in a manner that makes economic sense for their employers. If we fail to do that, we may be consigning millions of Americans to "do it yourself" retirement planning.

We thank you for this opportunity to testify and I'd be happy to answer any questions you may have.