

**TESTIMONY OF MARC E. LACKRITZ
ON BEHALF OF
THE SECURITIES INDUSTRY ASSOCIATION**

**BEFORE
THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS
THE COMMITTEE ON EDUCATION AND THE WORKFORCE**

**UNITED STATES HOUSE OF REPRESENTATIVES
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Good Morning. I am Marc Lackritz, President of the Securities Industry Association ("the SIA"). The SIA is a trade association comprised of over 740 broker-dealers who provide services to the hundreds of thousands of plans covered by ERISA, holding over \$7 trillion in plan assets. Because the SIA's members are parties in interest to every ERISA plan, through provision of brokerage services, investment advice, or as plan sponsors, they are faced every day with the complicated web of ERISA rules that govern their behavior and affect the manner in which they can serve and sponsor these plans. We appreciate the opportunity to appear before the Subcommittee and to comment on the regulatory structure surrounding the investment of ERISA assets. Just last year, Congress boldly took the steps necessary to permit modernization in the financial services industry in the form of the Graham Leach Bliley Act. We are gratified that this Subcommittee is now turning its attention to ERISA. This effort is a natural follow up to the changes authorized last year by Congress. It is also timely.

Our members would like to underscore the importance of helping Americans save and invest for retirement. With the aging of the baby boom generation, the United States is facing a potential retirement crisis. Social Security and Medicare's financial woes are well-known and it is very likely that these federal programs will not be able make up such a large part of future retirement income security for many of our workers. Congress and the Administration must act soon to shore up the private pension system and personal savings vehicles to ensure that workers can be prepared.

It is vital that our regulatory regimes keep up with the developments that have occurred since ERISA was enacted if plan sponsors and participants are to benefit. There is a great challenge ahead for the Department of Labor and the other regulators who oversee financial services. The securities markets are undergoing a major reorganization as we enter the next century. Technology is a driving force. Thanks to technology, 37 percent of all retail trades were done on-line last year. In 1995, we had no on-line investors. At the end of 1999, more than 5.6 million people invested on-line. Daily trading volume is 66 times what it was 25 years ago.

Affiliations among banks, broker-dealers and investment advisers have increased substantially. While Gramm-Leach-Bliley could result in additional mergers in the industry, new entrants will spur more competition. Take the example of on-line brokers. In 1994, there were no on-line brokers. Now, more than 200 are in business and driving down commission costs. Twenty-five years ago, few U.S. banks and broker-dealers had foreign parents; today, several of the largest financial institutions are owned in whole or in part by foreign financial institutions. Twenty-five

years ago, few global custodians were affiliated with broker-dealers; now, more than half of the largest custodians have broker-dealer affiliates. Twenty-five years ago, the largest investment managers were banks and insurance companies; today, the assets of plans are invested by a far broader spectrum of the financial community.

SIA would like to stress that the modernization legislation will benefit, not hurt plan sponsors and beneficiaries. During the debate over the legislation, former Secretary of the Treasury Robert Rubin testified that the "separation of banks and securities firms makes providing financial services less efficient and more costly."¹ Treasury estimates put the cost savings to investors at \$15 billion. Make no mistake; financial services reform will bring tangible benefits to plan sponsors and participants.

Twenty-five years ago, there was no thought of participant self-direction of investments; today, more than 25 percent of American households invest in an IRA and over 40 million invest their own 401(k) balance. The markets have changed, with lower commissions, alternative trading systems, a move to more transparent pricing in the fixed income and unlisted equity markets, increased use of derivatives, futures overlay strategies and equitization of cash based on the use of futures. Securities and Exchange Commission ("SEC") rules, which were the template for many of the ERISA class exemptions, have been substantially changed in the past 25 years.

These differences create conflicts with the constraints of ERISA, which were conceived at a time when affiliations among plan service providers were far less common. The framework of ERISA assumed that plans would be served by U.S. registered investment advisers, U.S. banks and broker-dealers, investing largely in domestic securities. Today, affiliations are global, and service providers to plans may well be foreign entities. The constraints of ERISA and the structure that it imposes, which were based on practices that have long since been overtaken by consolidation and globalization, often keep financial institutions from providing the most effective and efficient service to plans, and ultimately to plan participants and beneficiaries. Aside from substantially increasing the transactional and administrative costs of effecting transactions for plan accounts, such constraints often deny plans - and ultimately the participants and beneficiaries - the opportunity to participate in beneficial investments or to take advantage of them in a timely or cost-efficient basis manner.

ERISA sets forth both affirmative duties of a fiduciary and prohibitions applicable to fiduciaries and to parties who deal with the assets of plans or entities that are related to such parties. The affirmative duties are straightforward and reflective of the common law of trusts: to act solely in the interests of participants, to act prudently, to diversify the assets of the plan, and to follow the terms of the plan. The SIA does not believe that these affirmative obligations have interfered with the efficient and effective investment of plan assets.

The statutory prohibitions present different challenges. These so-called prohibited transactions essentially outlaw all transactions between plans and those who deal with plans in the broadest possible terms, establishing absolute structural prohibitions to certain types of plan transactions and fiduciary conduct in the absence of an exemption. These prohibited transaction rules serve in effect as per se prohibitions against certain types of transactions, notwithstanding the fact that the transaction may be "fair" or even beneficial to the plan.

The prohibited transaction rules fall into two categories. Section 406(a) focuses on the relationship between a plan and "parties in interest" and precludes a fiduciary from causing a plan to engage in certain transactions with such parties. ERISA defines the term "party in interest" to include: (i) a party who has some direct relationship to the plan even if he is not a plan fiduciary, e.g., a plan service provider; or (ii) a party who has no such direct relationship to the plan but who is related through ownership or otherwise with direct parties in interest, e.g., certain affiliates of plan service providers. ERISA § 3(14).

Section 406(a) provides in relevant part that in the absence of an exemption, a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect --

- (A) sale or exchange, or leasing, between the plan and a party in interest;
- (B) lending of money or other extension of credit between a plan and a party in interest;
- (C) furnishing of goods, services, or facilities between the plan and a party in interest; [or]
- (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan;

ERISA § 406(a)(1).

Section 406(b) prohibits a fiduciary from acting in his own interest or for his own account, from acting in any transaction on behalf of a party whose interests are adverse to the plan's and from receiving a payment from a third party in connection with a transaction involving the plan.

When ERISA was enacted, it included a handful of statutory exemptions from the prohibited transaction rules, with further provision for individual and class exemptions to be issued by the Department of Labor.² Almost immediately, it was clear that the workload on the Department would be enormous. The sheer volume of exemption applications has resulted in delay that undermined the relief ultimately obtained. In large measure, it is the way the prohibited transaction provisions are written and the standards that the Department is required to meet in granting an exemption that have made ERISA so unwieldy.

In the first five years after ERISA was passed, the Department exempted a large variety of transactions, mirroring exemptions under the securities laws and reflecting the normal investment practices of financial institutions, as the ERISA Conference Report had directed.³

Other class exemptions have been issued since that time, but increasingly, they lag behind the comparable SEC exemptions in timing and in scope, and reflect the Department's view that protections that are deemed to be sufficient for advised accounts and investment companies that are regulated by the SEC are inadequate to appropriately protect retirement assets. Investors do not need different protections depending on whether they are saving inside a retirement plan or outside such a plan. ERISA needs to be clarified so that the Department is not compelled to take different positions from the SEC on precisely the same facts.

At any point in time, the Department of Labor may have 150 to 200 individual requests pending for exemptive relief. They range from the simplest of transactions (sale of property between a plan and a plan sponsor) to the most complex (the underwriting of certificates in a trust that holds receivables and uses swap transactions as a hedge). The amount of financial knowledge that review of these exemption applications requires should not be underestimated. We would urge the Congress to approve more staff, and higher-level staff for the Department to handle these sophisticated transactions.

The Department has taken positive steps to streamline the exemption application process and we applaud these efforts and the creativity that the Department has shown recently in looking for new ways to make the existing process work better. For example, many individual exemption requests can be expeditiously dealt with through an innovative exemption procedure promulgated by the Department in 1996. The so-called Expedited Exemption Procedure class exemption ("EXPRO") (PTE 96-62) permits an applicant to obtain expedited treatment of the exemption request (generally 78 days rather than the more typical 12-18 month period for normal consideration of an exemption request) if two other substantially identical exemptions have been granted in the previous five years. Nearly 100 exemptions have been authorized under this procedure in the last 3 years. While we wish that the Department were less demanding of absolute identity between the requested EXPRO exemption and the two models on which it is based, it has been extensively used by the financial industry and has eliminated substantial delay and minimized the cost of the exemption process.

In addition, in 1984, the Department issued an exemption which allows virtually all section 406(a) transactions, assuming that the transaction is directed by a qualified professional asset manager or QPAM. The QPAM exemption (PTE 84-14) has made an enormous difference in the everyday securities and real estate leasing transactions that previously were required to be the subject of individual exemptions.

Other exemption requests, however, present new or complex financial transactions that are quite common for non-plan investors and are routine under the securities, banking or insurance laws. However, because these transactions involve technical violations of the prohibited transaction provisions, they require a specific individual exemption from the Department of Labor. We believe that there are a number of statutory changes that would benefit plans and their participants as well as improving the exemption process. We would like to work with you to achieve those changes.

A Statutory Exemption for Investment Advice

One of the most difficult exemption areas has been the provision of investment advice to participants in defined contribution plans. As I have already mentioned, one of the most striking trends of the last 25 years is the move from defined benefit to defined contribution plans and the move from professional asset management to participant self-direction of investments. An unintended result of this shift is the quandary that it has presented to plan sponsors and plan participants.

When ERISA was enacted, by far the greatest concentration of ERISA assets was in defined benefit plans that were professionally managed. Today, assets in defined contribution plans exceed the assets in defined benefit plans. The significance of this fact cannot be underestimated; millions of Americans are responsible for investing for their own retirement security - and making investment decisions over far greater amounts than they are responsible for in any other area of their lives. Most participants are not schooled in investment management, risk/return strategies, asset allocation and the like. They have neither the time nor expertise to follow investment trends, market movement, or global economics. They are teachers, electricians, secretaries, carpenters, sales staff, assembly line workers - the retirement contributions will be of little value if participants do not have the advice that will enable them to properly invest those assets.

Participants are presented with a dizzying array of choices for investment of their retirement account. They have little or no guidance regarding how to make these investment decisions. Plan sponsors are reluctant to provide advice for several reasons. The first is that generally speaking, investment advice is not the business they are in. They are simply not equipped to provide advice to participants. In addition, they do not want to be deemed to be fiduciaries with respect to their participant's investment choices, with the liability that such a status entails. While an industry is beginning to spring up to provide investment advice to participants, the most obvious place to look for this advice is the existing financial community. ERISA, however, makes the provision of advice difficult for affiliates of the banks, insurers and investment advisers that provide investment products to plans. If the adviser is affiliated with the sponsor of any of the investment vehicles available to participants, a conflict is presented which could result in a prohibited transaction. If fees for the advice are offset from management fees payable from the investment vehicle, then the investment managers of the investment vehicle are underpaid. The problem arises when the choices available to a participant are all advised by an affiliate of the person providing advice to participants, because the Department is concerned that the asset allocation advice would favor the asset class from which the affiliates receive the highest fees. The problem also arises when the choices available to a participant include proprietary and nonproprietary products, because the Department is concerned both with bias in the asset allocation and bias in the vehicle recommended. The Department has struggled with various iterations of investment advice exemptions but would be the first to recognize that none have been totally successful in achieving the industry's objective to ensure that advice will be a reality. All of the exemptions that have been issued thus far have been based on a relatively high advice fee to accommodate the internal vehicle fee offsets that the Department has traditionally required or on the presence of an independent fiduciary to give asset allocation advice. Neither of these constructs is ideal. In our view, it is not enough to provide a web site and a computer program to provide information; participants have questions, concerns, uncertainty that is often most effectively flushed out in face-to-face conversations. Questionnaire answers are often an overstatement or understatement of how the participant really feels in terms of risk. Any solution, either administrative or statutory, needs to be geared to the realities of participant decision-making.

In our view, the most vital action that the Committee can take is to provide an investment advice exemption in the statute based on the kind of disclosure that is the hallmark of the securities laws. For example, a statutory exemption could require disclosure of all fees to affiliated parties

and all conflicts of interest, as well as comparable past performance information. That one statutory exemption would probably eliminate more than a dozen pending exemption requests, all of which are complicated and time-consuming. Moreover, a statutory exemption would significantly help all participants to find their way through the investment thicket of their plans, rather than approaching this problem provider by provider through the administrative exemption process. Our members believe that in the absence of some usable structure for the provision of investment advice to participants, we will have created a retirement system that encourages employer contributions and employee savings but permits those assets to be underinvested, resulting in inadequate retirement income for millions of American workers.

Regulatory Inconsistency

The complaint we hear most often from our members is that the rules governing institutional funds are inconsistent, making compliance needlessly complex and a trap for the honorable but unwary. The SEC and the banking regulators permit advised accounts, investment companies and bank collective funds to cross-trade; the Labor Department has ruled that such trades violate ERISA. Benefit plans that are subject only to the Internal Revenue Code may cross-trade; benefit plans subject to both ERISA and the Code may not. Direct transactions between investment advisers and their advised non-ERISA accounts are permissible with consent; they are flatly prohibited under ERISA. Any mutual fund or bank pooled fund can use its affiliated broker-dealer or futures merchant to execute transactions, so long as appropriate disclosure is made in advance; the rules regarding use of one's affiliates under ERISA are far more restrictive. ERISA permits self-directed plans to avoid most of the fiduciary and prohibited transaction rules; the Code contains no similar provision. As a result of this inconsistency, the very same transaction for the very same plan is not a prohibited transaction under ERISA but is prohibited under the nearly identical provisions of the Code.

This kind of statutory inconsistency is extraordinarily difficult and creates additional compliance burdens that increase costs to all plans. Layered on top of this structure are the inconsistent or uncoordinated responses from the various regulatory agencies to similar problems. For example, the SEC issued an exemption permitting an investment manager to purchase securities in an underwriting when its affiliate was a manager of the syndicate in 1997; the Department of Labor has only this year proposed such exemptions. While the industry is very pleased with the underwriting exemption, and will undoubtedly use EXPRO to obtain nearly universal relief, many of our members wonder why the SEC and the Labor Department could not have considered these exemptions at the same time and in a more coordinated fashion. Such an approach would not have necessitated duplicative expense and time for what is virtually the same relief from different agencies. Perhaps it is unrealistic to expect that a legislative mandate will compel interagency cooperation and coordination. Nonetheless, the current regulatory inconsistencies are unacceptable. We think it would more constructive for the agencies to coordinate their initiatives so that the industry is put to the expense of making its case just once. We think the result will be significant savings to plans and their participants.

The system of exemptions provided for in ERISA is critical to efficient financial market transactions. By statutory design, that system depended on a flexible, responsive system of individual and class exemptions. Instead, it has proved to be cumbersome, time-consuming and

expensive. The statute contains some exemptions for transactions such as: necessary and appropriate services, loans to participants, employee stock ownership transactions, bank deposits so long as the bank is a U.S. or state supervised bank or trust company, insurance contracts, bank ancillary services (again requiring a U.S. or state supervised bank or trust company), and bank collective fund investments - the Department's views of those statutory exemptions is often conservative, requiring resort to additional administrative exemptions. Often, regulations under existing exemptions or advisory opinions interpreting existing exemptions might be a less time-consuming and costly method of ensuring that these exemptions are not abused.

Additional Recommendations

There are a variety of changes that Congress could make that would go a long way toward reducing the workload of the Department, freeing up staff to deal with more universal investment issues while still protecting participants and beneficiaries. Any change to the prohibited transaction provisions of ERISA must begin with the recognition that no changes are recommended in section 404 of ERISA. Section 404 requires that a fiduciary act "solely in the interest of participants and beneficiaries", a standard which would of course be violated if a fiduciary acted in violation of the three prohibitions in section 406(b). Thus, whatever we recommend with respect to the prohibited transaction provisions, and whatever action the Committee and the Congress ultimately take, leaves firmly and completely in place the seminal protections of the fiduciary responsibility requirements of ERISA.

With that in mind, we think that section 406(a) needs to be refocused. We do not recommend repeal; instead, we recommend that it be recast to mirror the protection afforded participants in the Federal Thrift Savings Plan, enacted more than 10 years after ERISA, with the hindsight that enabled Congress to build a better model. The Federal Employees Retirement System Act ("FERSA") was enacted in 1986, after the Department of Labor had more than 10 years of experience with the prohibited transaction provisions of ERISA. The counterparts in FERSA to ERISA section 406(a) violations are much like Code section 503(b), which applied to plans before ERISA was passed, prohibiting sales and exchanges of property and the provision of services only where the transaction is not for adequate consideration. Like Code section 503(b), FERSA does not prohibit extensions of credit from a party in interest to a plan. And FERSA only prohibits extensions of credit from a plan to a party in interest if the interest rate is not reasonable. It would be a relatively simple but very helpful legislative change to amend section 406(1)(1)(A) through (D) and section 4975(c)(1)(A) through (D) to track the more reasonable rules of FERSA. That change alone would eliminate a huge number of very common prohibited transactions.

Another change that would be enormously helpful is to conform the definitions of party in interest in section 3(14) of ERISA to the analogous provision in the Internal Revenue Code. That definition excludes upstream affiliates of service providers and fiduciaries, and excludes employees. In addition, the definition of party in interest captures all partners of parties in interest, rather than what we assume was meant, based on how FERSA defines party in interest - partners in parties in interest. These clarifications and conforming changes are relatively simple, but enormously helpful in a statute that is overbroad and complex.

Administrative exemptions can be issued on a class or on an individual basis, but in all cases, the process is lengthy, notice and comment is required in the Federal Register, and hearings are often required. From both the applicant's point of view and the Department's point of view, the system is less than perfect. Unlike the SEC, the Department has no ability to give a temporary exemption pending the issuance of a final exemption, so transactions are held up, waiting for the process to work. The "no-action" procedures used by the SEC created a category of transactions, which, while technical violations of the statute, have been structured in a way to protect participants and minimize self-dealing. A similar provision in ERISA structured as a temporary exemption without notice, comment or the opportunity for a hearing may provide some of the same relief that is available under the no-action procedure.

The globalization of plan investing has increased the Department's workload as well. The existing statutory and class exemptions are framed in terms of U.S. registered broker-dealers, U.S. or state-supervised banks, U.S. registered investment advisers. For the Department to expand the relief of these exemptions, it must find that the exemption is in the interests of plan participants, protective of them, and administrable. Those findings require knowledge of the regulatory structure of foreign banks, broker-dealers, and advisers that is difficult to obtain and verify and which makes the exemption process lengthy and expensive. A statutory exemption for foreign banks and broker-dealers that piggybacks on all of the exemptions granted to U.S. banks and broker-dealers would be helpful. Similarly, the rule on foreign custody of assets has added confusion in our industry as plans have increasingly invested more of their portfolios in global investments. It would be a relatively simple legislative change for Congress to amend section 404(b) to permit foreign custody of assets by any regulated foreign depository or any foreign bank with a minimum of net capital or that is supervised by a banking agency in its home country.

The Department has struggled with the issue of bonding for broker-dealers and advisers for several years now. Congress could readily provide that no additional bonding is required for these individuals if they are bonded in compliance with the securities laws. It seems axiomatic that if the bonding required under the securities laws protects the individual investor, it equally protects those investors in their capacity as participants and beneficiaries.

The important change would be to add an analog of ERISA section 404(c) to the Internal Revenue Code. Under section 404(c), a whole variety of transactions are not treated as prohibited transactions if the investment is participant-directed and the plan meets the requirements of section 404(c). Because no similar provision exists under the Code, IRAs and self-directed plans are still subject to the prohibited transaction provisions of the Code and their attendant excise taxes. At the very least, the SIA strongly suggests that Congress add a provision to the Code which tracks section 404(c) of ERISA.

Conclusion

In conclusion, the SIA firmly believes that changes are needed in the prohibited transaction provisions of ERISA to recognize the changes in the financial industry, the changes in plans, and other regulatory regimes. We would be pleased to work with the Subcommittee to craft statutory

changes that will benefit participants and beneficiaries at the same time that it modernizes and streamlines the regulatory framework that governs retirement plans.

Footnotes:

¹. Testimony of Treasury Secretary Robert E. Rubin before the House Committee on Banking and Financial Services, March 1, 1995.

². Originally, the Department of the Treasury and the Department of Labor issued exemptions jointly. As a general matter, responsibility for the prohibited transaction rules of the Code was transferred from the Treasury Department to the Department of Labor pursuant to Reorganization Plan No. 4 of 1978, Exec. Order No. 12,108, 44 Fed. Reg. 47713 (1978).

³. Among the exempted transactions were the purchase and sale of securities on directly between a dealer and the plan, the purchase and sale of insurance contracts by a fiduciary, the purchase and sale of mutual funds, the sale of securities in an underwriting where an affiliate of the fiduciary is a member of the syndicate, and the loan of securities to a party in interest.