May 6, 2009

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

Hearing on "401(k) Fair Disclosure for Retirement Security Act"
Health, Employment, Labor, and Pensions Subcommittee
Committee on Education and Labor
U.S. House of Representatives
April 22, 2009

The Investment Company Institute[1] appreciates the opportunity to file this statement for the record in connection with the Subcommittee's hearing on April 22, 2009, on the "401(k) Fair Disclosure for Retirement Security Act" (H.R. 1984). The Institute appreciates the willingness of the Subcommittee and the full Committee to listen to our views as it considers H.R. 1984. We agree with the approach taken by the bill to ensure that participants receive key information on all investment products. Disclosure that is focused and useful to participants serves an important role in helping workers be better savers and better investors. However, the Institute believes H.R. 1984 is flawed in several respects, and we cannot support it in its current form.

Below we reiterate our support for an effective disclosure regime that provides useful information to employers and plan participants. Then we address our concerns with H.R. 1984.

Improving Disclosure

The Institute has consistently supported meaningful and effective disclosure to 401(k) participants and employers. In 1976 – at the very dawn of the ERISA era – the Institute advocated "complete, up-to-date information about plan investment options" for all participants in self-directed plans.[2] We also have consistently supported disclosure by service providers to employers about service and fee arrangements.[3]

Disclosure reform should address gaps in the current 401(k) disclosure rules. The Department of Labor's current participant disclosure rules cover only those plans relying on an ERISA safe harbor (section 404(c)); no rule requires that participants in other self-directed plans receive investment-related information. In plans operating under the safe harbor, the information participants receive depends on the investment product, resulting in uneven and difficult to compare disclosure. Disclosure reform also should clarify the information that service providers must disclose to an employer on services and fees to allow the employer to determine the arrangement is reasonable and provides reasonable compensation. Where the service provider's services include access to a menu of investment options, employers should receive from that provider information about the plan's investments, including information about fees.

Initiatives to strengthen the 401(k) disclosure regime should focus on the decisions that plan sponsors and participants must make and the information they need to make those decisions. The purposes behind fee disclosure to plan sponsors and participants differ.

Participants have only two decisions to make: whether to contribute to the plan (and at what level) and how to allocate their account among the investment options the plan sponsor has selected. Disclosure should help participants make those decisions. Participant disclosure should focus on key information about each investment option – including its objectives, risks, fees, and performance – and information about any other plan-level fees assessed against the participant's account. Voluminous and detailed information about the components of plan investment fees could overwhelm the average participant and could result in some employees deciding not to participate in the plan or focusing on fees disproportionately to other important information, such as investment objective, historical performance, and risks.

On the other hand, plan sponsors, as fiduciaries, must consider additional factors in hiring and supervising plan service providers and selecting plan investment options. Information to plan sponsors should be designed to meet their needs effectively.

Plan sponsors should obtain information from service providers on the services that will be delivered, the fees that will be charged, and whether and to what extent the service provider receives compensation from other parties in connection with providing services to the plan. These payments from other parties, commonly called "revenue sharing" – but which are really *cost sharing* – often are used in a variety of service arrangements to defray the expenses of plan administration. Requiring a service provider to disclose to plan sponsors information about compensation it receives from other parties in connection with providing services to the plan will allow the plan sponsor to understand the total compensation a service provider receives under the arrangement. It also will bring to light any potential conflicts of interest associated with payments from other parties in connection with the plan's services or investments, for example, where a plan consultant receives compensation from a plan recordkeeper.

<u>Concerns with H.R. 1984</u>

H.R. 1984 is intended to close the gaps in current law by setting out the rules for disclosure of service provider compensation and ensuring that participants in all participant-directed defined contribution plans have information on the investments available to them, regardless of type. However, many of the details of the bill need improvement, and in some cases the bill includes unprecedented and unnecessary provisions that are not related to improving disclosure.

It is difficult for affected parties to read the bill and know what information about investment products must be disclosed and who must disclose it. The bill uses imprecise language and undefined terms that service providers will have to interpret broadly in order to avoid the bill's penalties, resulting in disclosure that is confusing to plan fiduciaries and participants and unnecessarily costly to prepare. Lack of certainty on the disclosure requirements also could lead to less standardized disclosure, which makes comparisons more difficult.

Many of our concerns with the bill arise because the bill confuses a 401(k) plan's *services* with its *investments*. Plan sponsors and participants need disclosure about both. But without some important clarifications, the bill will force investment disclosure into a service provider box, which will add unnecessary costs that will be borne by participants.

A disclosure regime needs to recognize the central role that recordkeepers play in providing investment information on plan investments. When a plan contracts with a recordkeeper to receive administrative services and access to investment products, the plan fiduciary needs to know the services to be provided, the direct and indirect compensation the recordkeeper receives and the fees and other key information about the investment products used by the plan. As is routine best practice now, plan recordkeepers consolidate information on plan investments into a single and useful form, as they have a direct relationship and contract with the plan. Recordkeepers, through their contracts with mutual fund firms, insurance companies, and other investment providers, ensure they have the information they need to provide disclosure on plan investments. Recordkeepers rely on the information provided to them, since for many products it typically comes from disclosure that investment products make under other laws (a point the bill recognizes).

Unfortunately H.R. 1984 does not recognize this central role played by recordkeepers. It defines a contract that requires individualized disclosure 10 days in advance to include "the offering of any investment option." In addition, it defines "service" to include "a service provided directly or indirectly in connection with a financial product in which plan assets are to be invested."

The Institute also is concerned that the bill contains an unprecedented mandate that 401(k) plans offer an index fund of a specific type and requires full service recordkeepers to disclose separate charges for recordkeeping even when there are no separate charges.

Below we detail the Institute's primary concerns with the bill. The bill has other technical and substantive problems about which we will provide comments separately to Committee staff.

A. <u>INDEX FUND MANDATE</u>

- As a condition of section 404(c) liability relief for the investment decisions of plan participants, the bill imposes a new condition that the plan sponsor select an index fund. (p. 27, line 13). The requirement is inappropriate and sets a dangerous precedent for the government to pick the investment options for private 401(k) plans.

- It is not clear what fund would satisfy the requirement to match the performance of the entire United States equity or bond market and in addition is "likely to meet retirement income needs at adequate levels of contribution" for any participant. This requirement includes both an objective and a subjective standard. An S&P 500 index fund, which is the most common index used in equity index funds, would not appear to meet the objective standard. In addition, it is not clear what fund would meet the subjective standard, because no one index fund is a single investment solution for all retirement savers in all markets. Accordingly, although 70 percent of plans currently offer a domestic equity indexed investment,[4] it appears that very few plans could satisfy this provision now. In addition, the subjective standard exposes plan fiduciaries to significant new liability in selecting index funds for plans.

B. <u>SERVICE PROVIDER DISCLOSURE</u>

<u>Section 111(a)(1) – General requirements</u>

- The bill apparently would make a <u>mutual fund</u> that offers an investment option to a plan a service provider, because anyone offering an investment is treated as offering a contract for services. (p. 2, line 21-22). The apparent result is that a plan must receive a separate and individualized disclosure from each investment product, rather than (as we expect was intended) the plan receive a single disclosure that lists the fees of all of the plan investments. An investment product like a mutual fund would not have the data necessary to estimate how much of the plan's assets will be invested in that fund. In any event, mutual funds are prohibited by federal law from negotiating with individual shareholders over the fees to be paid for a particular share class of the fund.

- The bill also appears to make <u>a person that provides services to a mutual fund</u> a service provider for purposes of the new disclosure requirements. This is done through the expansive new definitions of "service" and "service provider" under section 111(e)(2) and (4) – which confuse the important distinction between the *investments* a plan makes with the *service providers* it engages. (p. 19, lines 13 and 23). These provisions indicate that anyone providing services to an investment option in which a plan invests is treated as providing services that are subject to the new disclosure requirements and is an ERISA plan service provider. For example, mutual funds have virtually no employees so, along with the fund's investment adviser, funds engage numerous accountants, lawyers, printers, brokers, and others to provide services to the mutual fund. The definition of service and service provider in the bill would indicate that ERISA plan fiduciaries must receive a disclosure concerning all of the services and "charges" paid by a mutual fund to any mutual fund service providers and to fund directors. Relevant information about all the payments a mutual fund makes to its service providers is disclosed in SEC required documents. H.R. 1984 would go beyond that without justification. This provision cannot be reconciled with the provisions in ERISA that exclude service providers to mutual funds from being treated as ERISA plan service providers. See ERISA § 3(21). This provision is unworkable since a mutual fund may have hundreds of service providers, including scores of brokers. Of course, ICI believes that revenue sharing and other payments received by recordkeepers from mutual funds, investment advisers or other entities should be disclosed by the recordkeeper and that plan fiduciaries should receive basic information on the expenses associated with investing in the fund.

<u>Section 111(a)(2) – Unbundling and transaction fees</u>

- Requiring unbundling of recordkeeping charges even when there are no separate charges for the services will result in inaccurate and misleading numbers that favor one business model over another. (p. 3, line 16). Since the estimates required under the bill will not be based on market transactions, service providers face significant liability risk even for reasonable attempts to comply with the requirement.

- There is no definition of "transaction-based charges." (p. 3, line 24). We expect this is intended to cover items like the sales charge (load) on investments, and the costs for accessing individual plan services like plan loans. (A similar provision in the participant disclosure portion of the bill is clearer on this point.) Because of the expansive definition of "service," however, this could be read to require disclosure of internal commissions and transaction costs within a pooled investment product. These are not operating expenses or fees but part of the capital cost of acquiring and selling securities. Mutual funds are required to disclose the fund's portfolio turnover rate, the best measure of the cost of portfolio trading (and which allows comparisons among funds). In addition, funds make available in the Statement of Additional Information a host of information about commissions, including aggregate brokerage commissions paid during the last three years and information about the fund's trading policies.

<u>Section 111(a)(3) – Total dollar amounts</u>

- Requiring disclosure of total dollar amounts when a particular fee is charged on another basis (like percentages or basis points, or as a charge per usage) requires a service provider to make a number of assumptions. (p. 4, line 6). For example, the service provider will need to predict to which investments participants will direct their accounts, and how often participants will use a particular plan feature like loans. The estimate is only as good as the underlying assumptions. This is why a service provider often provides dollar estimates when it believes that it can make reasonably accurate assumptions (long-standing plan which has a consistent history of participant behavior) and may not provide a dollar estimate when it cannot (brand new plan starting with zero plan assets). For example, assume a plan without a loan feature adds one that will require a $20 loan fee for each new loan. How is the service provider to estimate how many loans will be taken out?

<u>Section 111(a)(6) – Financial relationships</u>

- The disclosure of financial relationships is potentially very broad and vague. It is unclear what it means to disclose "the amount representing the value of any services." (p. 5, line 16). It is also unclear whether this requires a service provider to disclose the services and value of the services (even without actual payments) that are made between the service provider and its affiliates. Plan fiduciaries need to know total compensation paid under an arrangement and actual payments. Requiring disclosure of the value of services provided by affiliates does not apprise the fiduciary of any conflicts that are not otherwise apparent and could require disclosure of amounts that are not actually paid between affiliates.

- In fact, we believe that the disclosure of direct and indirect compensation as well as compensation earned by an affiliate in connection with plan services – already required by the bill – will be more effective than requiring a service provider who is not a fiduciary to determine that it may have a material financial relationship triggering disclosure. ERISA's prohibited transaction rules already prohibit transactions between the plan and parties-in-interest and prohibit fiduciaries from self-dealing.

- If this provision is applied within a mutual fund, it will require extensive information of little value. For example, it could require a disclosure that various entities within an integrated fund complex purchase joint insurance and other common practices involving mutual fund affiliated transactions, all of which occur only in compliance with stringent safeguards under the Investment Company Act of 1940 and SEC regulations.

- The requirement to disclose any personal, business or financial relationship with the plan sponsor, the plan and any plan service provider or affiliate thereof will be nearly impossible to satisfy. (p. 6, line 9). For example, this provision would be triggered if the plan's accounting firm happens to switch its 401(k) recordkeeper to the same recordkeeper that services the employer's plan. It will be impossible for one service provider to monitor constantly whether it is doing business with another plan service provider or its affiliate.

C. PARTICIPANT DISCLOSURE

Section 111(b)(3)

- The bill requires that fees be disclosed to participants in the actual dollar amount rather than on a percentage basis. (p. 15, line 5). Service providers currently do not collect or provide fee information on this basis and it will be extremely expensive to create the systems to report the actual dollar amount of fees associated with each participant account. While it would be possible to provide a fee estimate based on a snapshot of a participant's account (e.g. based on the asset allocation and balances in a participant's account on a particular date), this disclosure will undermine a participant's ability to compare costs of different investment options. For example, if a participant has 90% of his or her account invested in a fund with a 0.40% (40 basis point) expense ratio and 10% invested in a fund with a 1.00% (100 basis point) expense ratio, the participant might think the first fund is relatively expensive and the second is cheaper. Comparability is best measured through use of percentages or basis points or through a representative example (such as the dollar amount of fees for each investment for each $1,000 invested). This is why the SEC, which has looked at this repeatedly over the years, requires mutual funds to disclose the expense ratio up front and a representative example in the front of the prospectus and in shareholder reports.

Section 111(c) – Electronic disclosure

- The bill does not sufficiently promote electronic disclosure. Electronic disclosure should be the presumed method of disclosure to plan fiduciaries and participants and paper copies should be available on request.

<u>Section 111(d) – Application to insurance and bank products</u>

- The bill needs to be modified to ensure that there is a sufficient level of fee disclosure for traditional fixed interest insurance and bank products. The bill simply requires that the Secretary of Labor issue rules to *identify* products that provide a guaranteed rate of return. The bill should direct the Secretary to require disclosure that alerts participants to the risks and economics of these products, for example that the cost of the fixed return product is built into the stated rate of return because the insurance company or bank covers its expenses and profit margin by any returns it generates on the participant's investment in excess of the stated rate of return.

<u>D. EFFECTIVE DATE</u>

- Allowing only one year for service providers and plan administrators to come into compliance with the provisions is unrealistic. DOL will not have issued final rules implementing the statutory provisions with enough time for service providers to adjust during that period.

* * * *

The mutual fund industry is committed to meaningful 401(k) disclosure, which is critical to providing secure retirements for the millions of Americans that use defined contribution plans. We thank the Committee for the opportunity to submit this statement and look forward to continued dialogue with the Committee and its staff.

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $9.71 trillion and serve over 93 million shareholders.

[2] Letter from Matthew P. Fink, Associate Counsel, Investment Company Institute, to Morton Klevan, Acting Counsel, Plan Benefit Security Division, Department of Labor (June 21, 1976).

[3] See Statement of Investment Company Institute on Disclosure to Plan Sponsors and Participants Before the ERISA Advisory Council Working Group on Disclosure, September 21, 2004, available at http://www.ici.org/statements/tmny/04_dol_krentzman_tmny.html.

[4] Profit Sharing/401k Council of America, *51st Annual Survey of Profit Sharing and 401(k) Plans* (2008).