**U.S. House of Representatives**
**Committee on Education and Labor**
**Subcommittee on Health, Employment, Labor, and Pensions**

# Hearing on "Retirement Security: The Importance of an Independent Investment Adviser"

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(presented orally in abbreviated form)

It is an honor for me to have been asked to speak today, and it is my privilege to be here. I am here personally, not on behalf of my firm or any client.

I start on this topic from the perspective that there is a problem. The problem is that maybe the most important investment capital in this country - assets in participant-directed 401k plans – is in the hands of the people least qualified to invest that money - rank-and-file plan participants. One need only look at my own not-so-stellar stock picks, if you want to use me as an example.

I'd like to take a step back and spend a moment reviewing the evolution of the system and how we got to where we are. Initially, defined benefit plans, with their promised benefit and with investment risk on the employer, were the cornerstone of our retirement policy. Congress understandably upped the ante on the regulation of defined benefit plans, in an effort to protect the pension promise and take some of the heat off of the Federal insurance program. Funding rules tightened, administrative and other expenses increased, and the rules relating to liability for plan underfunding were substantially tightened. The result of this well-meaning regulatory evolution was a flight from defined benefit plans to individual account plans, and a shift of investment risk to the employee.

Two other things then happened. One was Congress's approval around 1980 of a system of tax-advantaged elective deferrals – 401(k) plans. Essentially, the Treasury became a partner in the provision of employee benefits, as all of the cost of the salary deferrals came from the employee, and yet the benefit to the employee came not from the employer but from the benefits of tax deferral. Employers could supplement this benefit with profit sharing and matching contributions, but the heart of the system became the employee's own elective deferral.

At about the same time, practice, technology, and the law fostered a trend to participant-directed investments. Participants, particularly younger participants more focused on the here-and-now, liked this trend for the control it gave them, particularly in the context of a plan that, with its relatively straightforward account statements and easily understood account balances, was generally more appealing to the average participant than the defined benefit plan. This trend was fueled by the perception during the internet boom that the accounts could only go up. The question wasn't whether the accounts would grow; the question was high they would go.

Then, the internet bubble burst, and there became a lot more focus on the abject lack of capacity that people had to manage these critical assets. But there was no way to turn back this clock. Defined benefit plans were essentially gone, and defined contribution plans were with us to stay . . . with the result that this critical portion of the biggest lump of money in the world – as retirement assets have been called - came to be managed by those least capable of managing it.

When employers and financial institutions moved to provide real advice to participants, they immediately became faced with ERISA's fiduciary standards, which have been referred to as being among the highest known to the law. The general self-dealing rules are extremely inflexible, as they should be, and neither notice nor fairness is enough to cleanse justify prohibited conflicts of interest. As a result, many advisory services available in the market cannot feasibly be provided in connection with an ERISA plan. In addition, some employers have been concerned under the general prudence rules that arranging for advice, if not under a type of program affirmatively endorsed by Congress or Labor, could be risky.

Thus, ERISA has had the general effect of discouraging financial institutions from providing advice to participants and of discouraging some employers from arranging for advice even when it is available in the market. When the employer has been willing to make the move, frequently, under ERISA's legal framework, the only feasible alternative from the plan's existing providers has been computer-driven model-type advice, rather than true personalized advice.

I've felt for some time that the inability of participants to get employer-facilitated investment advice of the type that other investors can get is one of the greatest problems with our retirement system. I think it's pretty clear that employees want this advice, and that employers want them to have it.

An emerging question is: why shouldn't we let ERISA's general rules continue to bar the advice if there is a conflict? In effect, why not allow the advice only if it's conflict-free? Well, because you may want the widest range of expert personnel providing this critical advice, and at some point, at least in the case of advisers already involved with the plan or its investments, the only permissible structures may not make business sense. ERISA is chock full of legislative and administrative exceptions to its general rules, where there is a judgment that policy considerations justify divergence from general principles, and where safeguards are viewed as striking the proper balance. That it can be shown that a particular course requires some divergence from general principles does not provide a final answer – if it did, there would be no exceptions whatsoever. Maybe the right answer here is what I'll call "conflict-safe," rather than conflict-free.

Put another way, we want not only to protect participants but also to help them, and you don't always want to tilt everything towards one side of the coin. Many of ERISA's fiduciary rules are designed to balance protection with approaches that make business sense, so that players in the market are incentivized to remain players in the market and to provide needed services. What good is it if participants are protected regarding services which no one is willing to provide? In this case, I think, you want to encourage the provision of the advice, but with adequate safeguards.

On one extreme, it could be argued that, since advisers are otherwise regulated, there is no need for any additional gloss under ERISA. This approach, however, would ignore that the role of the advice is in connection with retirement plans, and that special considerations, essentially growing out of ERISA's concerns regarding conflicts, may arise.

So, what is it that makes the retirement context so special, that would justify an additional overlay of ERISA regulation? An understanding of that question could lead to an understanding of where a proper balance can be struck. Is it because of the rank-and-file nature of the participant base? Is it because of the fiduciary component of ERISA money management? Is it because of the peculiarly long-term nature of the presumptive investment strategy for retirement assets? Well, maybe all of this and more indeed justify special ERISA rules and regulations for advisers in this area. But does it justify a total lack of trust for an industry that generally is otherwise intensely regulated?

I would suggest that the ERISA context justifies inquiry such as the one taking place here today, but does not support a complete lack of faith in the entire industry. On balance, I think that the issue of conflicted advice, as it's come to be called, is a substantial one. It is one that needs to be addressed before anyone gets comfortable that an exception to ERISA's well-crafted fiduciary rules is appropriate. I do not think, however, that concerns about conflicted advice should lead to the conclusion that inside advice – advice provided by one already providing services to the plan or with respect to its investments - can never feasibly be permitted. Indeed, I think that the tone of the discourse would benefit from the use of a more neutral term like "inside advice," as compared with the more pejorative "conflicted advice."

Let's look at what we presently have under the approach in Labor's fee-leveling regulations. One key aspect of the analysis relates to identifying the parties whose fees need to be leveled. The Department looked at the statutory language and concluded that the requirement applies at the adviser level. I thought that, here, a good and thoughtful balance was struck by Congress in the PPA, as interpreted by the Department. The idea is that the individual adviser would be required to be insulated from the perspective of his or her own compensation, while the regulated entity would be trusted, if you will, to conduct itself appropriately. The hope, then, was that fee-based incentives at the institutional level would not be enough to cause the individual to skew the advice. I came to believe that this balance made sense, if we were going to want these institutions to bring their expertise to bear on helping participants. Indeed, if you take the fee-leveling requirement too high up the chain, so that the fees to the institution as a whole are unaffected by the advice, you start not to need the exemption at all, as you will come close to eliminating the conflict altogether.

My take on the separate class exemptions in the regulations, the ones that go beyond what is specified in the statute, is that Labor personnel wanted to craft these exemptions not to allow abuse, but to refine Congress's work consistently with the parameters and principles that Congress laid out. I don't think I'm being naive here in describing the Department's approach. I again, believe that the Department wanted to facilitate the delivery of true and useful advice consistently with congressional intent.

At this point, I just want to say a word or two about my perception of the regulatory process that led to the final rules. I think that the Department looked carefully at the statute and tried to craft rules that implemented Congress's wishes in a workable way. I know there has been some rhetoric regarding a slant in favor of the financial institutions, but my experience with

Labor personnel - from the top to the bottom - has been that they are highly focused on protecting participants and beneficiaries, often to the significant consternation of employers and financial institutions. Indeed, a number of what I would characterize as strained interpretations are interpretations that slant substantially against - not towards - employers and financial institutions. But that is what they felt they needed to do, in order to do the right thing. Here, the Department was faced with Congress's groundbreaking attempt to make meaningful investment advice broadly available. Implementation of the new rules was presumably to the benefit of participants, and so the question became: how best to implement?

I can understand that any given compromise or balance struck by lawmakers and regulators thus far is not necessarily the perfect one. I can also understand that Wall St. and the prior administration are in the cross-hairs right now. But if there are shortcomings in the rules than let's address them – shortcomings don't mean that the motives of the regulators were inappropriate. Nevertheless, I think that it is critical to address the issues by attention to the various competing policy considerations and by a focus on the manner in which the various rules fit together, so that decisions now can be made in the contemplative way that these important issues deserve. Ultimately, if we can permit the provision of well-intentioned professional advice in an appropriately safeguarded way, we will have done well for the participants we are trying to help and protect. If we're going to conclude that we simply cannot find a way to permit this needed advice to be delivered, well that, I think, would be unfortunate. If the effect of regulation, however well-meaning, is to bar or disincentivize desired conduct and services, then the regulation may failure to achieve its true goal.

Regardless of what you may think about the present rules, I see efforts like those you are making here today as hopefully leading to workable exceptions that strike the right balance. If we agree that this advice should be available, than workability needs to be a paramount consideration. The key to me is finding the balance between workability and safeguards - neither one being to the exclusion of the other.

If we're now going to decide that Congress or the Department may not have gotten it exactly right, I hope that we wind up with a set of rules that encourage the provision of advice with proper safeguards. One thought I had was to encourage the adviser to present alternative investment strategies with increased levels of conservatism, together with an explanation of the potential value of conservatism. In any event, I agree that we don't want rules that are used, if they're susceptible to being used in an abusive way. Likewise, though, if we wind up with rules that are safe but unused, we haven't addressed the crying need that we have today. And I do think that participants and employers alike are crying out for readily available, personalized, tailored, non-mechanical advice from expert professionals that know and understand the participants and their plans.

Arguably, to be sure, the outside third party is more insulated from conflicts of interest than an inside provider would be. But that is the beginning of the inquiry, not the end of it. The questions then become: is there value to permitting the provision of inside advice, and are the restrictions that surround the inside provider sufficient? I think that an advantage of doing so would be to permit the efficient use of expert advisers who may already be familiar with the plan and its investments, and who may be willing to provide the advice on a low- or no-cost basis as a part of the services generally being offered. Thus, if the inside adviser is used, you get the efficiencies that come with not having to bring in third parties. The use of inside

advice could give rise to efficiencies from operational and cost perspectives; there could be ease of integration and communication. Having said that, an employer would of course always be free to arrange for the use of an outside third party, and make use of that more insulated expertise, if it were to be decided that such a choice were best for the plan.

If where we ultimately come out is that only the use of true third parties not otherwise involved with the plans is sufficiently safe, then so be it. I think that the cost of that determination, however, is that you would be giving up the benefit of having the largest institutions with the greatest resources be viable options for the provision of this advice. It is now evident that there will always be a valuable role for the independent third parties that have so capably jumped into this breach, and I certainly would tell a client that the third-party route is a viable and excellent choice. My point is just that the employer should also be free to choose the efficiencies and other benefits that could come with the use of a player already involved with the plan or its investments, if a reasonably safe way can be found to permit the employer to make that choice.

In closing, I would submit that the ERISA fiduciary context does not justify a wholesale abandonment of the securities regulation that governs the advisory community, but rather should inform a contouring of additional ERISA rules to the special circumstances applicable to plan participants and beneficiaries. Thus, if the importance and utility of a broad range of available advice is accepted, the Holy Grail here should not be the delivery of purely conflict-free advice – it should be the delivery of conflict-safe advice. At the end of the day, I think that it's critical that a broad range of effective advice be made available to participants and beneficiaries. We're not going to be able to turn back the clock on individual accounts and participant direction. To me, the greatest risk here is that the system fails to figure out a way to allow for the delivery of the best advice to those who need it most.

Thank you.