A·C·L·I AMERICAN COUNCIL OF LIFE INSURERS

FINANCIAL SECURITY FOR LIFE

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURERS

BEFORE

THE SUBCOMMITTEE ON EMPLOYER-EMPLOYEE RELATIONS

OF

THE COMMITTEE ON EDUCATION AND THE WORKFORCE

UNITED STATES HOUSE OF REPRESENTATIVES

ON

A MORE SECURE RETIREMENT FOR WORKERS: PROPOSALS FOR ERISA REFORM

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I. Introduction

My name is Kenneth S. Cohen, Senior Vice President and Deputy General Counsel of Massachusetts Mutual Life Insurance Company. I am testifying today on behalf of the American Council of Life Insurers ("ACLI"). ACLI is the major trade association of the life insurance industry, representing 428 life insurance companies. ACLI member companies hold 80% of all the assets of U.S. life insurance companies and represent 82% of the industry's retirement plan business. Retirement plan assets managed by life insurance companies totaled more than $1.6 trillion in 1998, approximately one-fifth of all privately- administered pension and retirement plan assets in the U.S.

ACLI thanks the subcommittee for the opportunity to testify on this important topic and we welcome the Subcommittee's review of the Employee Retirement Income Security Act of 1974 ("ERISA"). More than 25 years ago, Congress enacted this landmark law that comprehensively regulates employee benefit programs. It is only appropriate that the Education and the Workforce Committee, which had a major hand in the development of ERISA and has sole jurisdiction over Title I of ERISA, conduct hearings to determine how well ERISA is working in light of changes in the nation's retirement system and developments in the financial markets. Since ERISA was enacted, the tax rules affecting pension plans, as well as the rules governing the pension insurance program administered by the Pension Benefit Guaranty Corporation (PBGC), have been changed frequently and the plans themselves have changed. However, Title I of ERISA – the reporting and disclosure provisions that apply to ERISA plans and the trust, fiduciary and prohibited transaction requirements – have only rarely drawn congressional scrutiny. Given the dramatic changes that have occurred in the last 25 years, it is time to review these rules and make sure that we have a retirement system that make sense in the 21st century - a system that works for all Americans.

When Congress adopted ERISA in 1974, among its key goals was to provide a safer and more secure system of providing retirement benefits. The funding, vesting, reporting and disclosure, fiduciary responsibility, civil remedy provisions, and pension insurance program set forth in ERISA have largely accomplished that goal. While there are certainly isolated instances of abuse – and such abuses must be policed and punished – the nation's retirement system has never been more secure. We continue to strongly support this fundamental goal and believe modernization of ERISA can be accomplished without sacrificing benefit security.

Although ERISA has largely been successful at protecting plan benefits, certain aspects of the regulatory structure have imposed significant costs on plan sponsors and those who provide services and investment products to plans. In many instances, these costs are passed through and directly borne by plan participants and beneficiaries. Other costs are borne indirectly in the form of lower benefits than those that would otherwise be offered or, for many Americans, a lack of pension coverage altogether. Costs are also imposed indirectly on plan sponsors and plan participants whose choices of new and innovative investment products may be needlessly limited by ERISA's regulatory framework. Finally, significant opportunity costs are imposed on the economy as a whole. Privately-administered plans held $7.9 trillion in assets in 1998 - two-thirds of all retirement savings and 25% of all household wealth. If we can remove unnecessary opportunity costs from this huge source of capital, the economy will be stronger and offer even more opportunities for growth and job creation.

The question is not whether to update ERISA's regulatory framework to address the sweeping changes that have taken place over the past 25 years, it is how that modernization can best be accomplished. Let us briefly review some of the major changes in the marketplace since ERISA's adoption.

Changes in the retirement plan marketplace. When ERISA was enacted in 1974, the nation's private retirement system was built around traditional defined benefit plans. Defined benefit plans typically pay benefits in the form of an annuity and payments are based on a combination of a participant's age, years of service, and wages. Employers fund defined benefit plans over time, manage plan investments, and bear the investment risks. The benefits are insured by the PBGC.

Since 1974 there has been a significant shift in the retirement plan marketplace toward defined contribution plans (*e.g.*, section 401(k)-type plans). Under a defined contribution plan, the employer, the employee, or both may contribute to an account that holds assets for the employee. Increasingly, plan participants may direct the investment of the assets held in their individual accounts among a number of options made available by their employers. In 1975, defined contribution plans held *$74 billion* in assets, 28% of total pension assets, and covered 26% of persons covered by private pensions. In 1999, defined contribution plans held *$2.9 trillion* in assets, 35% of total pension assets, and covered over half of persons covered by private plans.

In a related trend, since 1974 there has been tremendous growth in assets held in individual retirement accounts (IRAs were created in 1974). In 1998, IRAs held $2.1 trillion in retirement assets. Recently, this growth has been fueled by rollovers from defined contribution plans to IRAs.

Changes in investment vehicles and products. Over the past 25 years there also has been a dynamic change in the types of investment vehicles and services offered by financial institutions in the 401(k) plan and IRA market. One major change has been the proliferation of thousands of mutual funds offering a wide range of investment styles. In addition, insurance companies and banks have originated a variety of new "stable value" investment options for defined contribution plans that provide principal and interest guarantees for participant account balances and supplement the traditional guaranteed investment contracts (GICs) offered by insurance companies.

The development of these investment vehicles offers plan sponsors and plan participants an unprecedented range of investment alternatives in the defined contribution plan and IRA marketplace. It is now common for participants to be able to direct their own investments among multiple mutual funds and a stable value option within their 401(k) or 403(b) plan. Indeed, some plans are now offering participants the opportunity to invest in a nearly limitless variety of mutual funds and individual securities through "brokerage windows."

In our view, the shift to defined contribution plans and participant-directed investing creates one of the fundamental challenges for the private retirement system. Plan sponsors and participants increasingly require investment-related services. Services provided by financial institutions to 401(k)-type plans and IRA participants have developed to include participant education, asset allocation assistance and, increasingly, specific investment advice. The development of these services is critical to ensuring that defined contribution plan and IRA assets are invested wisely and in ways that will provide a significant benefit to plan participants. The law should be structured to encourage the efficient delivery of such services.

Changes in the financial services industry. During the last 25 years there also have been striking changes in the financial services industry. Clearly, with the recent enactment of the financial services modernization legislation (the Gramm-Leach-Bliley Act), the last barrier to a fully-integrated financial services industry has been removed. We would like to acknowledge the pivotal role played by Chairman Boehner as the leader of the bipartisan House Financial Services Task Force in the 105th

Congress. Under the Gramm-Leach-Bliley Act insurance companies and securities firms can now combine with commercial banks allowing banks to underwrite insurance products and securities through commonly-controlled affiliates. This new law could result in further consolidation in the financial services industry, making some of the problems posed by ERISA's current prohibitions against dealing with affiliated parties even more difficult and costly and further reducing plan participants retirement savings investment choices.

Even before financial services modernization legislation was enacted, substantial changes were taking place in the financial sector. As an example, over the past 15 years, many insurance companies have begun to offer a variety of financial services through subsidiaries and affiliates, including individual and group insurance, brokerage, mutual funds, trust and administrative services. Thus, today many insurance companies are able to offer products to 401(k)-type plans and IRAs that include both affiliated and unaffiliated mutual funds, several alternative stable value investment options, brokerage services, recordkeeping, individual account statements, and participant education.

II. Evaluation of ERISA’s Fiduciary and Prohibited Transaction Rules

ACLI member companies have a significant interest in all aspects of Title I of ERISA. However, we believe that the most important focus for the Subcommittee should be the fiduciary and prohibited transaction rules of Part 4 of Title I of ERISA.

Importantly, we believe that ERISA's trust requirement (section 403) and ERISA's fiduciary rules (section 404) have generally worked well. Under this framework, plan assets must be held in trust or in insurance contracts and plan fiduciaries must carry out their responsibilities prudently, act solely in the interest of plan participants, diversify plan investments, and administer the plan consistent with plan documents. These rules are rooted in the common law of trusts, and have proved flexible and responsive to changes in the retirement plan and investment markets.

There are, however, fundamental problems with ERISA's prohibited transaction rules (section 406). In our view, these problems have been heightened with the changes in the retirement plan and investment markets, and will worsen with continued consolidation in the financial services industry. Before we discuss potential changes to address these problems, let us first briefly discuss ERISA's prohibited transaction rules.

Section 406(a). Section 406(a) of ERISA includes a list of transactions between a plan and a "party in interest" that are flatly prohibited. Thus, there are two essential elements to a violation of section 406(a): (1) the transaction must fall in the categories of transactions barred by the statute, and (2) the transaction must involve a party in interest. The categories of party-in- interest transactions that are barred by the statute include:

- a sale, exchange, or lease of property,
- a loan,
- the furnishing of goods and services, and
- the transfer or use of plan assets.

It is hard to overstate how broad these categories of transactions are. Indeed, it is virtually impossible to conceive of a transaction that might not fall into one of these categories. For example, the purchase of stock is considered a sale of property and the provision of a free toaster for opening up an IRA is technically prohibited as a furnishing of goods and services.

Just as importantly, section 3(14) of ERISA defines a party in interest broadly, to include employers, labor unions, and service providers and the affiliates of such parties (including remote affiliates), as well as the officers and directors of all these entities and their relatives. In our view, the only persons who should be defined as parties in interest are those persons who can unduly and adversely influence a plan's activities for their own benefit. There is simply no justification for unaffiliated service providers to be included in the list of parties in interest. Because of the scope of ERISA's party in interest definition, it is virtually impossible for plans to know with certainty whether they are engaging in transactions with parties in interest. (For example, how can a plan possibly be aware of all the affiliates of a diversified financial services company such as MassMutual Financial Group?)

When one combines the broad categories of transactions that are prohibited, along with the broad definition of who is a party in interest, it is possible to see how unworkable the basic framework of section 406(a) is. Section 406(a) does not have its roots in trust law. Instead, the party in interest rules were based on the Treasury Department's private foundation regulations, but in an effort to prohibit completely certain categories of transactions irrespective of whether any particular transaction is abusive, the ERISA definition has a much broader reach. To highlight how extreme these rules are, in the absence of an exemption, a plan flatly cannot purchase securities from a party in interest or, if the plan holds real estate investments, the plan cannot lease office space to a party in interest.[1] The prohibitions apply even if the service provider does not serve as a fiduciary and in no way influences the plan's decision to engage in the transaction.

Here is another example of a benign transaction that is prohibited by section 406(a). ERISA plans invest in insurance company pooled separate accounts that invests in real estate. It would be a

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[1] Such transactions would be prohibited sales or leases of property between a plan and a party in interest under section 406(a)(1)(A).

prohibited transaction for employees of the insurance company to stay at a hotel in which the separate account has invested.[2] A violation occurs even if the employees had no idea the hotel was owned by the separate account and received no special rate covering their hotel stay.

Obviously, it seems ridiculous that such transactions would be prohibited, but such situations violate ERISA unless the Department of Labor blesses the transaction. The Department of Labor ("DOL") has issued several class exemptions that provide relief for common transactions between plans and parties in interest in certain circumstances if the conditions of the exemptions are satisfied. (See PTE 84-14 (QPAM); PTE 96-23 (INHAM); PTE 84-24 (covering sale of insurance contracts); and PTE 90-1 (covering insurance company separate account transactions)).

Section 406(b). In addition to the party-in-interest transactions described in section 406(a), section 406(b) of ERISA includes general prohibitions against a fiduciary's engaging in transactions involving self-dealing or other conflicts of interest. In particular, section 406(b)(1) prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account. Section 406(b) of the statute could accommodate an interpretation that a self dealing violation occurs only where the fiduciary's actions adversely effect the interest of the plan and its participants. DOL, however, has adopted a "*per se*" view of this prohibition. That is, under its regulations, a fiduciary may be guilty of self-dealing if it acts in a transaction in which it has an interest, regardless of whether the fiduciary's acts

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[2] This would be a prohibited furnishing of goods, services, or facilities (the hotel) by a plan (those investing in the separate account) and a party-in-interest (employees of the insurer, which is a fiduciary investment manager of the separate account) under section 406(a)(1)(C). DOL class exemption PTE 90-1 provides relief for this transaction if its conditions are satisfied.

are nonetheless beneficial to the plan or its participants. DOL's expansive reading of section 406(b) is not required by ERISA's statutory language nor justified by experience.[3]

Excise tax penalties. Importantly, transactions in violation of section 406 could give rise to an annual 15 percent excise tax penalty under section 4975 of the Code (or a 5 percent civil penalty under section 502(i) of ERISA where transactions involve health and welfare plans). This penalty is assessed annually, that is, the penalty is assessed for each year in which the transaction goes uncorrected. Moreover, for certain types of transactions (*e.g.,* loans), the transaction is deemed to recur as a new and separate transaction every year the transaction goes uncorrected. Thus, for certain transaction the penalty "pyramids" over time.[4]

Statutory prohibited transaction exemptions. When ERISA was enacted, Congress recognized that certain transactions may be in the interest of plans even if they would otherwise run afoul of the prohibited transaction rules. Section 408(b) of ERISA includes a number of "statutory exemptions" for these transactions. Most notably, section 408(b)(2) provides relief for the provision of services between a plan and a party in interest. Some of the other statutory exemptions are directed at investment products, such as section 408(b)(8), which provides an exemption for investments in insurance company pooled separate accounts and bank collective trusts.

There are two major problems with the statutory exemptions. First, the exemptions have not been updated since ERISA's enactment and, therefore, reflect exemptions for products and services

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3 See *e.g.*, Donovan v. Bierworth, 680 F.2d 270 (2d Cir.), *cert denied* 459 U.S. 1069 (1982) an incidental benefit to a fiduciary does not violate ERISA section 406(b)(1).

4 For example, if the transaction were a $100 loan, the first year excise tax would be $15. If left uncorrected, a second $15 penalty would be assessed on the transaction in year two, but a second transaction also would be deemed to occur in year two. Thus, the second year excise tax would be $30. The third year excise tax would be $45, the fourth year excise tax would be $60, etc.

that were offered principally to defined benefit plans in 1974. Second, DOL has narrowly interpreted the statutory exemptions so that their application is quite limited. For example, DOL regulations construe the service provider exemption under section 408(b)(2) to only cover the party-in-interest restrictions of section 406(a) and not the prohibitions of section 406(b), notwithstanding the fact that the language of the statute provides relief for all of section 406.[5] Similarly, it took the DOL more than 20 years to issue guidance indicating that the statutory insurance company separate account/collective trust exemption (section 408(b)(8) described above) may provide relief from section 406(b) violations.

Administrative exemptions. The drafters of ERISA recognized that situations may arise that would prove beneficial to plans and participants but that would otherwise be prohibited by the statute so they provided a mechanism for a more efficient administration of the prohibited transaction rules. That is, section 408(a) permits DOL to issue individual and class exemptions from the restrictions of both section 406(a) and section 406(b) for prohibited transactions that are not exempted in the statute.

For many years, DOL issued a number of useful and timely exemptions for financial products and services.[6] But, financial products are developing at an incredibly rapid pace and the application of these exemptions to new products and services is not always clear. Moreover, it is a nearly an impossible task for the small agency within DOL charged with these matters to stay abreast of the rapid changes in financial products and issue exemptions in a timely manner. In addition, DOL apparently believes that the statutory standards for granting an exemption require them to step into the fiduciary's

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[5] Under this framework, the provision of fiduciary services by an unaffiliated person is not exempt under section 408(b)(2) if the fiduciary can in any way influence the amount or timing of the fees paid to it by a plan even if a separate independent fiduciary has approved the fee agreement on the plan's behalf. This significantly limits the exemption in circumstances where a fiduciary is hired to provide investment advisory or investment management services (*e.g.*, performance fees).

[6] See *e.g.*, PTE 84-24; PTE 86-128 (covers securities transactions effected by a fiduciary on an agency basis); PTE 90-1.

shoes and determine whether a particular transaction is prudent. This self-determined interpretation has imposed a chilling effect on the entire process. Increasingly, individual exemptions take one to two years to obtain and complex transactions can take many years. Significant class exemptions are even more difficult to obtain and can languish even longer.

These time frames make the administrative exemption process of limited utility in the fast-paced world of new investment products. By the time an exemption is obtained, the market may well have moved beyond the transaction in question. This has led to a situation where financial institutions incur significant costs in trying to structure products that comply with a patchwork of older DOL class exemptions or otherwise seek to avoid technical violations of prohibited transactions even though an alternative structure clearly would be more cost-effective. In some cases, institutions may not offer certain services and investment products in the ERISA market because the prohibited transaction rules are so unworkable and the DOL administered exemptions process is so cumbersome. Clearly, the current scheme imposes unnecessary direct and indirect costs on plans and participants, and significant opportunity costs on the investment market as a whole.

To their credit, DOL has made an effort to expedite the review of individual exemptions. For example, in 1996 DOL issued a class exemption (PTE 96-62) designed to provide expedited relief for transactions that are substantially similar to transactions that are the subject of two prior individual exemptions issued within the last 5 years. PTE 96-62 has improved the exemption process for routing transactions. In our experience, however, this class exemption has not meaningfully improved the exemptions process for complex transactions because of DOL's ability to limit its application on a case-by-case basis. In particular, PTE 96-62, commonly known as the “cookie cutter” exemption, is only available where a transaction is "alike in all material respects as determined by the Department, in its sole discretion." Needless to say, the cookie cutter process is not available, as a practical matter, for complicated investment products and services.

An even more significant problem with the exemptions process is that DOL increasingly regulates the design and economic terms of products, rather than relying on disclosure to, and consent by, a plan's fiduciary who must ensure that the product is appropriate for the plan.

Investment advice products provide a good example. With the shift to defined contribution plans, the expanded number of investment options and the shift of responsibility for investment decisions to participants, investment education and advice is becoming increasingly important. This is a critical service that participants want to receive and employers want to offer. And a service which everyone agrees would enhance retirement security. Under investment advice programs, the advisor may be an ERISA fiduciary by reason of providing specific investment recommendations. The advisor typically charges an investment advisory fee (*e.g.*, 1% of assets) that will be paid from the plan's assets. In addition, the advisor may receive additional fees that vary depending on which investment options are selected by participants.[7] The differences in fees received by the advisor based on participant investment decisions may create potential conflicts of interest for the advisor under section 406(b) of ERISA that require an exemption. For example, an advisor may be able to benefit itself if it steers plan participants into higher cost funds in order to maximize its fees. (Of course, such behavior also would violate the advisor's fiduciary duty to act solely in the interest of the plan participant when giving specific investment advice.)

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[7] For example, if the participant selects a mutual fund that is affiliated with the advisor, the advisory or an affiliate will receive an investment advisory fee from the mutual fund for its services in managing the mutual fund. If the participant selects an unaffiliated mutual fund, the advisor may receive a fee from the unaffiliated mutual fee for distribution or shareholder services provided to the fund.

In 1997, DOL issued an individual exemption to Wells Fargo that covers the provision of advisory services in connection with affiliated and unaffiliated funds. (PTE 97-12, 62 Fed. Reg. 7275 (Feb. 19, 1997)). In addition to significant disclosure obligations, the DOL requires the offset of virtually every fee paid from mutual funds against Wells Fargo's investment advisory fee. As a result of the offset, the Wells Fargo advisor faces no financial conflict of interest. However, the economics of the program are significantly affected. The "offset" arrangement imposed under the Wells Fargo exemption is similar to a number of prior exemptions for advisory programs that offered only affiliated mutual funds. (PTE 96-59, 61 Fed. Reg. 40000 (July 31, 1996) (Paine Webber); PTE 94-59, 59 Fed. Reg. 32024 (June 21, 1994) (Smith Barney)).

Later in 1977, DOL issued an exemption issued to TCW Group for a similar advisory service. After protracted negotiations, TCW convinced the DOL to eliminate the offset requirement from its exemption. However, in its place, the exemption requires that persons independent of TCW design and manage the asset allocation and advisory services offered under the program. PTE 97-60, 62 Fed. Reg. 59744 (Nov. 4, 1997). Although the TCW exemption does not require fee offsets, the exemption effectively requires that the advisory firm use an independent party to provide the key advisory services, a feature which is understandably viewed as undesirable by other financial institutions.

The Wells Fargo and TCW exemptions are instructive of DOL's approach to the exemption process. After examining the final exemptions, one might wonder whether any exemption is necessary for the services at all. In the Wells Fargo exemption, the service was effectively restructured to eliminate the fee conflicts that created the potential conflicts of interest requiring the exemption. In the TCW example, the institution ended up hiring an independent party who was free from fee conflicts to provide the fiduciary investment advice.

In addition to DOL's work on advisory exemptions, DOL's position on insurance company general account exemptions is also instructive. The insurance industry has worked closely with DOL on seeking exemptive and other regulatory relief associated with the fall out from the Supreme Court's 1993 decision in *John Hancock Mut. Ins. Co. v. Harris Trust Sav. Bank.* In that decision, the Supreme Court narrowly construed the definition of a "guaranteed benefit policy" under section 401(b)(2) of ERISA. The Court's decision left open the possibility that an insurance company's general operating account could be deemed to hold plan assets with respect to ERISA plans that hold insurance contracts. If section 406(a) and section 406(b) were applied to an insurer's general operating account, which under state insurance law must be managed to support all policyholders - not just ERISA plan policyholders - a myriad of potential prohibited transactions could occur.

Within two years of the Court's decision, DOL issued broad exemptive relief for party-in-interest violations under section 406(a) (PTE 95-60). However, DOL declined to provide relief from section 406(b) for the internal operations of an insurer's general account and for insurance company transactions with affiliates. DOL would not provide relief notwithstanding the exhaustive regulation that insurance operations are subject to under state insurance law (*e.g.*, financial solvency, investments, annual reporting, periodic audits, civil and criminal penalties).

III. Priorities and Options for Reform

ACLI believes that reform of ERISA's prohibited transaction rules should be the Committee's top priority. These rules involve real and significant compliance costs, which are ultimately borne by plan participants and beneficiaries, without making significant improvements to benefit security beyond the protections already provided by ERISA's fiduciary rules. Moreover, the rules can have the effect of limiting the choices of investment products and services offered to plan sponsors and participants.

Equally important to all Americans who are trying to save for their retirement, may be the opportunity costs associated with less efficient investment markets.

ACLI recommends that Congress direct DOL to take into account competing regulatory frameworks – such as state insurance laws and federal securities laws – when applying the prohibited transaction rules. An important contrast can be drawn by comparing ERISA's legal framework with federal securities laws, which adopt a different approach to regulating conflicts of interest.[8] For example, like ERISA, the Investment Advisers Act imposes fiduciary standards on persons who provide advice or exercise investment discretion with respect to client accounts. However, with respect to mutual fund transactions, the SEC has indicated that an adviser may receive both an investment management fee from a client and different fees from the mutual funds, provided the fees are disclosed to the client.[9] The SEC rulings contrast sharply with the approach DOL has taken in the exemptions process.[10] These same principles apply to other securities transactions under the Adviser Act.[11] We think the securities laws, which apply to many products sold by insurance companies and

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[8] Federal securities laws comprehensively regulate the conduct of brokerage firms and investment advisers with respect to client assets, whether or not those assets are also subject to ERISA. See, e.g., Securities Act of 1933, 15 U.S.C. §§ 77a, et seq.; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, et seq.; Investment Company Act of 1940 Act, 15 U.S.C. §§ 80a-1, et seq.; Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1, et seq.

[9] See Advisers Act Release No. 1243 (July 23, 1990) (adviser permitted to received investment advisory fee from mutual fund); Advisers Act Release No. 1581 (Sept. 26, 1996) (adviser is permitted to receive commissions, 12b-1 fees, services fees from mutual funds if disclosure is made).

[10] Similar to its actions in issuing exemptions, DOL has issued advisory opinions indicating that a fiduciary's receipt of fees from a mutual fund will violate section 406(b)(1). DOL Adv. Op. 97-15 (May 22, 1997).

[11] For example, with respect to principal transactions, section 206(3) of the Advisers Act allows advisers to act as a principal in a transaction if they disclose "to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." 15 U.S.C. § 80b-6(3).

their affiliates (*e.g.*, mutual funds and registered separate accounts), could prove instructive as the Committee continues its oversight process.

Specific recommendations: ACLI believes that DOL has initiated process innovations that have eased the burden of compliance for the most routine transactions. We also believe that DOL can go much further to improve its exemption process under the current statutory structure. At the same time, we do acknowledge that DOL is constrained in what it can do by the inflexible mandates of current law and that significant improvements in the exemption process will require changes to the statute. To that end, ACLI has identified two broad approaches to reforming ERISA's prohibited transaction rules, both of which are outlined below. The first approach involves a fundamental and structural change to section 406(a) and section 406(b). The second approach involves significant - but more incremental - changes to section 406, the party in interest definitions in section 3(14), the excise tax penalties, and the administrative exemptions process.

1. Fundamental reform of ERISA's prohibited transaction rules.

One alternative would be to amend section 406 so that transactions would not be prohibited under either section 406(a) or section 406(b) if:

(1) the transaction, including any compensation paid, is carried out on arm's-length terms;

(2) the transaction involves a service or product that is necessary and appropriate to the operation of the plan; and

(3) where appropriate, the material terms and fees associated with the transaction are clearly disclosed in advance to a plan fiduciary or plan participants.

Under this structure, transactions that would otherwise violate section 406 would be permitted to proceed where they are nonabusive and in the interest of plans.

This legal framework would create a more flexible set of prohibited transaction rules that would be responsive to changes in the retirement plan marketplace and investment products. Moreover, such a change would not undermine the protections that ERISA provides for plans and participants. In this regard, assets would still have to be held in trust and fiduciaries would have to act prudently and solely in the interest of participants. Fiduciaries who breach these duties would be subject to the panoply of civil remedies under section 502, including personal liability for compensatory damages payable to the plan under section 409, and criminal sanctions under Title 18 of the United States Code.

2. Incremental approach to reforming ERISA's prohibited transaction rules. A second approach would be to pursue a number of changes to ERISA's prohibited transaction rules that would ease the administration of the rules without fundamentally changing section 406. While not as sweeping as the first approach discussed above, each of items discussed below would be a significant improvement as compared to current law. Adding new statutory exemptions follows ERISA's original model of exempting certain transactions that Congress finds to be in the interest of plans and participants. However, over the long term, this approach would be less flexible, and will not be responsive to market innovations as would an approach that fundamentally alters section 406.

- **Add a series of new statutory exemptions to section 408(b) of ERISA.** Congress could update ERISA's statutory exemptions to take into account changes in the retirement plan marketplace. The most important new exemption would cover investment education and advisory products. Such an exemption should be broad -- covering mutual funds, individual securities, and insurance and bank products. The exemption should rely on disclosure and consent, but it should not regulate the services or fees associated with investment education and advice products.

- **Narrow the definition of a party in interest**. Under current law, it is very difficult for plans to determine if they are entering into a transaction with a party in interest. This problem will worsen with the expected consolidation in the financial services industry. In our view, parties-in-interest should be a functional definition, in other words, it should be limited just to persons who can act on behalf of a plan in a manner that is adverse to the interest of the participants. For example, the definition of a party in interest should be modified to exclude service providers and their affiliates because they do not have the authority to act on behalf of the plan. Under this approach, parties in interest would be limited to employers, unions, and certain fiduciaries. In addition, the definition of an affiliate of a party in interest could be narrowed to exclude certain remote affiliates (*e.g.*, 10% owners). (This approach is much more in keeping with the Private Foundation Rules upon which the party-in-interest definition was based.) Such a change would not cut back on any protections that section 406(a) might provide, but it would simplify the administration of the party in interest restrictions greatly.
- **Revise statutory standards for individual and class exemptions.** As noted above, the process for obtaining an exemption is too time consuming and DOL imposes conditions that affect the design of products and fee arrangements. One approach to address this problem would be to revise the statutory standards that apply to issuing an exemption under section 408(a). An appropriate standard would require DOL to find that (1) the exemption is administratively feasible, and (2) protective of the rights of participants and beneficiaries. DOL should not have to conclude that a transaction "in

the interest" of plans as it must under current law. It is the plan fiduciary's job under section 404 to determine that a transaction is prudent and in the interest of the plan and its participants. Other procedural requirements, such as the imposition of certain time frames, might also be considered.

- **Create a self-correction program for purposes of prohibited transaction excise tax penalties.** Parties that inadvertently violate section 406(a) should be permitted to correct the violation without having to pay excise taxes if they correct the violation within a certain period of time after discovery. DOL has been considering a self-correction program for fiduciary violations and the IRS has many programs that allow plan sponsors to correct tax code violations. It would make sense to apply the same sort of approach to parties that discover an inadvertent prohibited transaction and correct it. As has been the case with the IRS programs, such a program may actually encourage plan sponsors and parties in interest to audit their plans for compliance. One obstacle to a self-correction program is ERISA section 502(l) which mandates a 20% civil penalty pursuant to any settlement agreement with DOL. The 20% civil penalty should be discretionary, not mandatory. We believe that DOL would support this change.
- **Eliminate *Federal Register* notice requirement.** Under current law, DOL is required to publish proposed and final prohibited transaction exemptions in the *Federal Register*, thus extending the time period required to obtain approval. A better approach would be to require simply that the applicant notify interested parties of the exemption and that DOL post the final exemption on its website.

- **Clarify temporary, interim, and emergency exemption authority.** We understand that DOL currently takes the position that it can issue exemptions only upon request and the filing of a formal application. DOL should be given the explicit authority to issue temporary, interim, and emergency exemptions on its own initiative.

Our testimony has focused on the need for reforming ERISA's prohibited transaction rules. However, there are many other areas within Title I of ERISA that are also worthy of review. For example, ERISA's co-fiduciary rules (section 405) have been interpreted expansively by the courts. These rules should be revised to reinforce the basic principle that a fiduciary is liable only for the acts that are within the scope of his fiduciary responsibilities (*e.g.*, the plan's claims administrator is not liable for the acts of the plan's investment manager).

In addition, section 403 and section 404 of ERISA permit the use of plan assets to pay the reasonable expenses of the plan. Recent DOL guidance has created significant uncertainty as to what plan expenses may be paid from plan assets in the event that the services provided to the plan might also benefit the plan sponsor. In fact, we understand that DOL has pursued enforcement actions against plan sponsors who charged the expense of nondiscrimination testing to the plan. In our view, such expenses are appropriate plan expenses and are not for the benefit of the plan sponsor. Section 403 and 404 should be clarified to ensure that a plan may properly pay expenses of the plan even where an incidental benefit may be conferred on the plan sponsor.

Another area worthy of exploration is how to encourage plan participants to elect forms of benefit distribution that provide income they cannot outlive. ERISA should be amended to encourage the accessibility of guaranteed lifetime income distribution options by making it less administratively burdensome for plan sponsors to offer them.

In sum, this Committee is to be commended for tackling this difficult, although enormously important, problem. ACLI is anxious to work with you to create a regulatory structure that maximizes the potential of our retirement system and our financial markets. In this way, we can truly help all Americans prepare for retiring in the 21st century knowing that their benefits will be secure and that they will have had an opportunity to take advantage of our investment markets to the maximum extent possible so that they can accumulate sufficient assets for a comfortable retirement.

Finally, let me note that this is an ongoing project for the ACLI. We would appreciate the opportunity to continue to work with the Committee and supplement the record as we develop further thoughts.