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On behalf of the Securities Industry and Financial Markets Association
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Before the ERISA Advisory Council
On Employee Welfare and Pension Benefit Plans
Working Group on Fiduciary Responsibilities Update and Revenue Sharing

Good Morning, Ladies and Gentlemen. My name is Laura Gough and I am Managing Director of Corporate and Executive Services for Robert W. Baird & Co. I am here today representing the Securities Industry and Financial Markets Association ("SIFMA").[1] SIFMA is pleased to have the opportunity to testify before you concerning the revenue sharing practices of defined contribution plans, and we hope that our comments will be helpful to the Advisory Council in formulating recommendations as to the need for guidance in this area.

I will begin by providing some background information about revenue sharing arrangements and the basis upon which they are determined. In providing this background information, I will talk about the confusion created by the use of the term "revenue sharing" and emphasize the need for greater clarity in the terminology used to describe different types of revenue streams. I will then turn to address the subject of guidance that might be issued by the Department of Labor regarding the proper use of any plan assets resulting from a plan's receipt of these payments, and how any such assets should be allocated to participants. In addressing these questions, I will highlight the need to take into account the different rules and regulations

[1] The SIFMA is the product of a merger of the Securities Industry Association and the Bond Market Association. The SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers to accomplish common goals. SIFMA's primary mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally.

from the SEC and other regulatory bodies in issuing any such guidance. Finally, I will address the subject of guidance that might be issued by the Department concerning what plan sponsors need to know and what service providers should be required to provide when considering such arrangements.

Background

Revenue sharing in its broad sense has allowed the marketplace to develop efficiencies and innovations that have enhanced the quality of services and products available to retirement plans. Broadly speaking, revenue sharing supports a wide variety of distribution and shareholder servicing activities, including administrative, recordkeeping and sub-transfer agent services that were traditionally viewed as investment fund responsibilities. The market has determined that it is more cost-efficient for broker-dealers, third party administrators and recordkeepers to perform these shareholder services than it is for the investment funds to perform the services themselves, and many of these services have proven to be particularly important in the retirement plan market.

In retirement plans, the asset manager pays a third party administrator or recordkeeper to keep records for the plans and their participants. The alternative would be to burden the fund's transfer agent function with individual accounts. Plan investors benefit from increased efficiencies in this type of recordkeeping arrangement because the third party administrator or recordkeeper can consolidate information from different investment funds and provide a single account statement for each participant that details all of the participant's account holdings. Because this is the same type of recordkeeping that the plan itself would have to perform, the revenue sharing payment to the recordkeeper essentially covers an administrative expense that the plan otherwise would have to bear.

Revenue sharing arrangements and the services they support have facilitated greater diversity in the investment products available to plans. Investors have a multitude of choices as to the funds they wish to buy, how they wish to pay for those funds and the services that support those investments. Today there are more than 15,000 registered investment companies – mutual funds, exchange traded funds, closed-end funds and unit investment trusts – with more than $11 trillion in assets held by nearly 100 million investors.[2] Revenue sharing has also encouraged greater use of non-proprietary investment options by retirement plan service providers, particularly in the small to medium size plan market. The availability of non-proprietary investment options increases investment flexibility. At the same time, however, moving away from proprietary investment options can make it more difficult for plan providers to maintain profitability. Revenue sharing has allowed plan service providers to offer non-proprietary investment options, improve services and maintain profitability without increasing prices. It has also had the effect of "democratizing" fund ownership, since larger shareholders in effect subsidize the costs of providing shareholder support and investment services to smaller shareholders.

Before going further, SIFMA would like to emphasize the need for greater clarity in the terminology used to describe the particular revenue streams that we are talking about. Revenue sharing is a broad term that means many different things to different constituencies. There is an inconsistency between the use of the term revenue sharing in the securities industry and the way the term is used in the employee benefit plan community. In the employee benefit plan

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[2] *See* Investment Company Institute, *2007 Investment Company Fact Book* (47th ed.), available at http://www.icifactbook.org/.

community, the term “revenue sharing” is used loosely to describe virtually any payment that a plan service provider receives from a party other than the plan.

That is not how “revenue sharing” is commonly used by the securities industry, the Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA”). “Revenue sharing” is generally used by the securities industry, the SEC and FINRA to refer to payments by a fund advisor or distributor to a broker-dealer out of the advisor’s or distributor’s revenues or profits. It does not include payments made to broker-dealers through 12b-1 plans, sub-transfer agent fees, or otherwise from an investment fund’s assets. Revenue sharing in this more limited sense may be used to reimburse a broker-dealer for distribution or marketing expenses, including sales, training and educational conferences or materials, or other marketing support activities intended to ensure that registered representatives are knowledgeable about the funds being offered. Because a broker-dealer acts for its own account in providing such distribution and marketing services to funds, the revenue sharing payments received by the broker-dealer are not attributable to any specific customer of the broker-dealer.

Unlike sales charges, 12b-1 fees, sub-transfer agent fees, redemption fees, deferred sales charges and other fees and expenses paid from investment fund assets, which are disclosed in a fund’s prospectus, revenue sharing payments have not been disclosed in a uniform manner. However, as I will explain in a moment, regulatory efforts are currently underway at the SEC that would require uniform disclosure of these revenue sharing payments by all broker-dealers.

If the ERISA Advisory Council recommends that the Department of Labor provide guidance on the revenue sharing practices of defined contribution plans, SIFMA would encourage the Council to emphasize the need for terminology that is consistent with the terminology used by the securities industry and the SEC. Distinguishing between revenue sharing payments from fund advisors and distributors and shareholder servicing payments made from investment fund assets will help simplify efforts by the industry to facilitate disclosure as well as to educate plan sponsors and fiduciaries who are responsible for selecting service providers and understanding the arrangements. At a minimum, SIFMA would encourage the Department to state clearly in any guidance what revenue streams it is referring to when it uses the term "revenue sharing."

Proper Use and Allocation of Payments

Any guidance as to the proper use and allocation of revenue sharing and account servicing payments should be closely coordinated with the applicable rules of other regulatory bodies. Investment products that are commonly found in defined contribution plans, such as mutual funds, bank collective funds and annuity contracts, are subject to the rules of a number of different government regulators. Those rules dictate the practices that have developed in the retirement plan marketplace.

As a general rule, ERISA does not prohibit the receipt of revenue sharing payments by plan service providers, nor does it require that any such payments be returned to the plan or its participants. The Department of Labor has indicated, however, that a plan fiduciary may violate ERISA's prohibition against self-dealing if it uses its discretion to increase its compensation (or the compensation of an affiliate) through the receipt of revenue sharing payments. For example, an investment advisor may engage in prohibited self-dealing if it provides investment advice to plan participants that results in the payment of additional fees to the advisor or its affiliate in the form of revenue sharing payments from funds that the advisor recommends. The Department has also recognized, however, that an investment advisor may provide investment advice with respect to investment funds that pay it or an affiliate additional fees without violating ERISA's prohibited transaction rules if the fees are offset against fees that the plan otherwise would be obligated to pay, or if the advice is provided through an independently developed computer model.

The SEC has proposed rules that would expand confirmation disclosure and institute a point of sale disclosure requirement for these revenue sharing arrangements.[3] The FINRA has also recommended to the SEC that investors be provided with an internet-based "Profile Plus" that describes the salient features of an investment fund, including basic information about these types of arrangements with a hyperlink to additional information in a dealer disclosure statement.[4] Although SIFMA generally supports enhanced disclosure of such revenue sharing arrangements, we would urge the Department of Labor to coordinate with the SEC to ensure that any disclosures required for plan investors are consistent with the disclosures required for non-plan investors.

Account servicing payments, by contrast, are typically made from 12b-1 streams or sub-transfer agency payments, rather than from revenue sharing payments as the term are understood in the securities industry. In practice, many third party administrators and recordkeepers have established separate expense accounts to hold payments from investment funds and their affiliates that are intended to cover account servicing expenses. Amounts deposited in these accounts are used to defray servicing expenses for the period in which they are received. At the end of that period, some recordkeepers may revert any unused funds to their general accounts,

[3] *See* SEC Rel. No. 33-8358 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004); SEC Rel. No. 33-8544 (Feb. 28, 2005), 70 Fed. Reg. 10541 (Mar. 4, 2005).

[4] News Release, *NASD Endorses Concise, Web-Based Point of Sale Mutual Fund Disclosure*, available at http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/P013727.

while others may reallocate any unused amounts to the benefit of plan customers and their participants.

The reluctance of many third party administrators and recordkeepers to reallocate or "rebate" unused shareholder servicing payments to plans and their participants is due largely to uncertainties created by other areas of law applicable to the investment products that make such servicing payments. Any guidance regarding the proper use of shareholder servicing payments that are "rebated" to a plan and the manner in which any such "rebates" should be allocated to plan participants should address how these servicing payments can be allocated to plans and their participants consistent with the regulatory constraints applicable to the investment products that generate such payments.

Mutual funds, for example, are regulated by the SEC, the IRS and state law. The SEC has indicated that any arrangement with a mutual fund under which a broker-dealer selectively rebates 12b-1 and/or administrative fees to shareholders within the same class (*e.g.*, plans) would indirectly treat some shareholders differently than others, thus raising "serious concerns" under the Investment Company Act of 1940 and "general fiduciary principles."[5] Even without such an arrangement between the mutual fund and the broker-dealer, the SEC has indicated that a broker-dealer's willingness to rebate any portion of 12b-1 payments to its customers raises questions for the mutual fund's board to consider in its review and approval of the fund's 12b-1 plan.[6]

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[5] *E*trade Securities, LLC*, SEC Ref. No. 2005511, 2005 SEC No-Act. LEXIS 805 (Nov. 30, 2005).

[6] *Id.*

Selectively rebating mutual fund fees to plans may also raise issues under the Internal Revenue Code. Mutual funds must satisfy strict requirements under Subchapter M of the Code to qualify as "pass-through" entities and avoid a double, corporate-level tax. If a mutual fund pays a "preferential dividend" within the meaning of Section 562(c), it will lose its eligibility for a dividends paid deduction and subject its shareholders to double taxation. Depending upon the circumstances, selectively rebating mutual fund fees to some shareholders and not others, or sending back compensation to the mutual fund complexes themselves, could raise a "preferential dividend" issue under Section 562(c).[7] This situation, which applies to funds both affiliated and unaffiliated with the various service providers to the plan, is a longstanding point of concern with mutual fund and tax attorneys supporting these complexes, and has not been the subject of any clarifying guidance from the Department of which we are aware on how to reconcile these requirements with the Department's views on offsetting.

Third party administrators and recordkeepers may receive similar servicing payments from bank collective trusts. Collective trusts are regulated by the Office of the Comptroller of the Currency ("OCC") and state law. OCC guidance on collective trusts expressly allows banks to consider services other than investment services in pricing trust participation interests. The OCC has indicated that a bank may charge different "management fees" to different classes of collective trust investors commensurate with the amount and types of services provided to each class, provided, among other things, that the fees are reasonable and that they are disclosed in the bank's written plan and at least annually in a manner consistent with applicable state law.[8]

[7] *See* IRS Rev. Proc. 99-40, 1999-2 C.B. 565 (Oct. 29, 1999).

[8] *See* Collective Investment Funds Comptrollers Handbook at 55-58 (Oct. 2005); OCC Interpretive Letter No. 829 (April 8, 1998).

Selectively rebating fees to some collective trust investors but not others may raise fiduciary responsibility issues, including questions about the reasonableness of the fees in the first instance and whether they were commensurate with the amount and types of services provided to investors in the fund.

Broker-dealers also may receive payments for services rendered on fixed and variable annuity contracts. These payments may be received from the insurer or from the entity that markets the contract, and are in addition to standard sales commissions and other fees. In addition, insurers acting as recordkeepers under variable annuity contracts may receive account servicing payments from underlying investment vehicles, including mutual funds and collective trusts. State laws applicable to these insurance contracts generally prohibit insurers from refunding premiums paid on the contract to the purchaser. Depending upon the circumstances, refunding these payments to the plan that purchased the contract may be viewed as an inducement or unfair discrimination by the insurer.[9]

Ignoring all of these regulatory constraints would likely give plan sponsors and fiduciaries the erroneous impression that there are no regulatory impediments to selectively rebating revenue sharing or shareholder servicing payments to plan investors, and potentially subject service providers (banks, broker-dealers, mutual fund advisers and insurers) to corrective actions by other regulators (the SEC, OCC, state insurance commissioners, etc.) in trying to comply with these and the ERISA regulatory requirements. As for allocating to participants any rebates that a plan may receive, the Department has already issued guidance that may be relevant

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[9] *See, e.g.*, N.Y. Ins. Law § 4224 (McKinney 2000) (general prohibitions on inappropriate inducements, including rebating, for life insurers, brokers and other intermediaries).

to plan fiduciaries in determining how such rebates should be allocated.[10] Any additional guidance on this subject should ensure that plan fiduciaries retain flexibility to choose the allocation method that best serves the interests of the plan and its participants under the facts and circumstances of each case. In particular, SIFMA believes it would be a mistake to require plan fiduciaries to calculate the precise dollar amount of any rebate attributable to a plan participant's individual account. The information necessary to perform this type of calculation generally would not be readily available to plan fiduciaries, and the cost of requiring fiduciaries to perform such a calculation is likely to exceed what could reasonably be justified.

What Plan Sponsors Need to Know and What Service Providers Should Be Required to Provide

SIFMA supports the Department's current regulatory initiative to improve the disclosure of service provider revenue information to plan fiduciaries through proposed amendments to the regulation interpreting the statutory exemption for services.[11] SIFMA believes that it is critical for plan fiduciaries to understand the revenues received by the plan's service providers, not only to determine the overall reasonableness of the plan's arrangement with the service provider, but also to ensure that plan fiduciaries are aware of any potential conflicts of interest or other biases their service providers may have in providing advice or recommendations.

At a minimum, SIFMA believes that such enhanced disclosure to plan fiduciaries should incorporate the following elements: (1) a clear, simple presentation of the expenses reimbursed by revenue sharing or shareholder servicing payments; (2) identification of investment providers

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[10] *See* Field Assistance Bulletin 2006-01; Field Assistance Bulletin 2003-03.

[11] 29 C.F.R. § 2550.408b-2.

that make revenue sharing or shareholder servicing payments; and (3) disclosure of the basis upon which revenue sharing or shareholder servicing payments are made by each investment provider.

Thank you once again for allowing me to testify on behalf of SIFMA today regarding these important issues. If you have any questions, I would be happy to try to answer them.