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**Testimony of**
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**Before the**
US Department of Labor, Employee Benefits Security Administration

**Hearing on**
US Fiduciary Rule, RIN 1210-AB32 and RIN 1210-ZA25

**August 12, 2015 (Panel 16)**

**Background:**

Good afternoon. I am Jean-David Larson, Director of Regulatory & Strategic Initiatives at Russell Investments. Thank you for affording me the opportunity to present my views here today.

Russell Investments is a global financial services firm that provides consulting, asset management, manager research, trading implementation and index services. Russell manages over $272 billion in assets, actively engages over 400 asset managers around the world, consults to some of the world's largest pools of capital (representing over $2.4 trillion in assets under advisement), calculates over 700,000 benchmarks daily (covering 81 countries and more than 10,000 securities),[1] and transitioned over $800 billion in client assets in 2014.

Our entire global business is built to serve the financial needs of our clients who are the organizations and people that drive our economy and are the backbone to retirement savings. Russell serves our clients exclusively on an *agency basis* and typically in a fiduciary status, putting our clients' interests first. Our long and deep heritage in financial services, combined with our breadth of experience across various client segments and global markets, provides us with a perspective on clients, regulators, markets, investment products, and investment solutions that inform the views that I will share with you here today.

**Introduction:**

Retirement savings is a social and national imperative. The positive externalities of adequate retirement savings are immense. In the US, total household savings is under 4% and is projected to decline further particularly due to low savings rates among younger workers. In 2012, the average US worker spent more on coffee than they invested for retirement. *We are a consumer culture*. The single most important action that we can do to improve retirement security is to save instead of spend. If we do not reverse this trend, under-saving will place our

[1] Figures are as of March 31, 2015.

economy and the majority of workers' standard of living in jeopardy, both in terms of long-term growth and our resiliency to economic or personal shocks.

It is our opinion that setting up a regulatory environment that fosters and promotes sound retirement savings practices is the imperative of our time. Retirement savings requires the cooperation among lawmakers, regulators, employers, and individuals. I would like to thank everyone at the Department for their tireless work in advancing this important piece of regulation and their cooperation with all stakeholders ….as is evidence here today.

Now, turning to my recommendations….. first I will make a suggestion about how to avoid disruption in the institutional market, then suggest two modifications aimed at the retail market, and lastly provide recommendations related to the suggested low-cost safe harbor.

**Institutional Market:**

The primary focus of the Department's analysis is on the *retail* segment of the market, not institutional. We support this focus given that the institutional market has more access to expertise *and* benefits from existing safeguards that protect their beneficiaries. I believe the Department shares this view and would agree that the institutional market generally functions well. Sweeping changes to what has evolved over ERISA's 41 year tenure would be very disruptive and for no clear benefit. The Department appears to acknowledge this by proposing a seller's carve-out for plans greater than 100 participants. *However*, I believe there is a more straightforward approach. My **first recommendation** is that you modify the proposed rule such that, by definition, it only applies to persons directly advising *individual* accounts or *small plans* (plans under 100 participants). This will avoid introducing unnecessary ambiguity, risk, and cost on the institutional market.

**Retail Market:**

Now to turn to the retail market…..

In the retail market, there is certainly some degree of confusion as to *when* or *whether* a financial professional is acting in a fiduciary capacity. Individuals *should* be afforded protections that enable them to *clearly* differentiate between providers and the levels of services and protections they are afforded. When individuals seek assistance from a financial professional to navigate *complex* retirement decisions, they *should* be able to rely on their agent to act with loyalty, care, and prudence.

The Department has received a great number of comments from others on these aspects of the proposals, so, I will focus my recommendations on an exemption and also on an area in need of further guidance or rulemaking.

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## ***Sophisticated investor exemption***

The Department recognizes that the retail market is not homogenous. Some investors are highly sophisticated, often using their financial professional for execution only or as a second opinion immediately prior to executing the investment they *already* had in mind. As a practical matter, many firms segment their clients along these lines since the more affluent clients require *and* can afford more services.

Therefore, my **second recommendation** is for the creation of a *sophisticated investor* exemption to allow them to opt out of certain aspects of the rule. In doing this, the Department would be emulating a well-established approach under securities law of providing relief to "accredited investors" or "qualified clients." This carve-out would enable firms to adapt their compliance programs, offerings, *and* sales efforts to fit the needs of their sophisticated clients with less disruption than what has been proposed by the Department.

## ***Small Investor rulemaking/guidance***

My **third recommendation** is that the Department accelerate work to enable state and private multiple-employer plans (MEPs) to move forward. This will significantly benefit small savers which is the segment that deserves the most attention. This is the segment that is most at-risk of being (further) underserved. While this segment could be helped through technology or other means, our collective efforts would fall short of *truly* helping them improve their financial security if we commoditized them in the same way that the advice to them is increasingly proposed to be commoditized.

### *Multiple Employer Plans*

As the Department notes in its analysis, many retirement accounts are either in an employer-sponsored plan or are the result of a rollover from an employer plan. Employers provide these plans as a competitive means of attracting and retaining employees. Larger employers may have the expertise in-house to set up such a plan or, in any event, are able to afford the cost of outsourcing that work. Smaller plans do not have these scale advantages. A plan is a *costly*, *complex*, and *burdensome* undertaking. As a result, upwards of over half of small US employers do *not* offer retirement plans today; that number jumps to 75% for employers with fewer than 25 employees. For those employers who *do* offer a plan, they and their participants often fall into the "small saver" category from an asset-based perspective.

While these companies are extremely diverse, the considerations they must weigh in *making* fiduciary decisions are largely the same….such as *what* models or asset allocation tools to use, *what* investment options to include, *which* provider to use, *whether* to enable features such as auto-enrollment, auto-contribution, auto-escalation, or an employer match. There are *significant* advantages to be gained if these small plans can leverage best-in-class designs and collectively pool their assets. The Department should facilitate the formation and servicing of these plans.

At the direction of the President, the Department will be providing guidance to US states regarding the status of state-sponsored MEPs under ERISA. This will clear the path for states to enact legislation and begin offering these much-needed solutions to small plans within their states. We eagerly await that guidance.

My **fourth recommendation** is to piggyback off the Department's state MEP efforts to facilitate the emergence of private or "open" MEPs. To the extent that changes in the proposed rule may cause small savers to be underserved, allowing these plans to organize under an MEP structure would not only mitigate that impact, it would also *vastly* improve their ability to deliver *higher* quality, *lower* cost solutions to their employees. It would further increase the propensity of small employers to set up retirement plans which, *by itself*, would be a *significant* contribution to improving national retirement security. While the acceleration of state MEPs *will* be significant, state MEPs *will* have their limitations and *will* likely (*and* rightly fully so) be focused on lower income participants. Open MEPs would provide an important bridge between *advisor*-advised plans and *state*-advised plans.

I understand the Department's reservations about for-profits establishing and running MEPs; *however*, with the proper controls and safeguards, a competitive private sector marketplace can create *innovative*, *efficient*, and *prudent* solutions that can help address the needs of this vastly underserved marketplace.

**Low-Cost Safe Harbor:**

The last item I will address today is the suggested "Low-Cost Safe Harbor" PTE. My **fifth recommendation** is that the Department not advance this proposed exemption and, *instead*, reformulate an exemption along the lines of a QDIA exemption (qualified default investment alternative exemption). This exemption would *only* be available for models and products that meet certain criteria, as is the case today. This would disproportionately benefit small savers and would be a better solution than what is proposed.

In designing portfolios, one should start with investment beliefs about what sources of return will perform well over the long-run and short-run. Then construct the portfolio using all three sources of exposure to ensure that the portfolio is designed to fit the client's needs. Lastly, dynamically monitor and manage exposures.

The three sources of return we employ in a total portfolio management approach are:

(1) ***index*** replicating strategies to capture a market segment's overall opportunity set including return and volatility, as well as the correlation of a given market segment with other investment opportunities;

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(2) ***smart beta*** strategies to express active factor positions in the short or long term. Like index strategies, these are transparent, rules-based strategies. These direct investing strategies enable professional investors to shape the portfolio to reflect investment convictions by adding desired or reducing unwanted exposures; and

(3) ***active strategies*** where we believe that active management from security or market selection can add value. This is particularly important because you can mix active strategies together to deliver higher returns for the same risk level or, conversely, less risk to achieve the same return.

Clearly there are *plenty* of passive products, however, there are no *truly* passive investors since every decision is inherently an active one ….*including*, at the time of its creation, decisions about which criteria to include in an index's composition.

There also are situations in which passive management *may not* be in the best interest of clients:

(1) Passive strategies still require active intervention for allocation *among* passive choices, a rebalancing strategy, and monitoring for appropriateness over time to ensure continued alignment to the investor's investment goals. How would an investor know which index to choose? Even if the Department were to proscribe market-cap weighted indexes, which ones would it prescribe? What weighting to each index is in client's best interests? These questions are difficult to answer and require active management to discern;

(2) Passive strategies are not clearly defined. For example, Russell calculates over 700,000 benchmarks daily, any one of which could be the basis for a "passive" strategy;

(3) Passive strategies may overlook significant sources of investment returns where smart beta or active management strategies have a better chance to outperform;

(4) Passive strategies may severely restrict the choice of indexes and loosely replicate the asset class for the sake of a low cost. Small cap, emerging market equities, or high yield debt indexes are all examples where replicating the opportunity set is more difficult in the form of an index; and

(5) Passive strategies may be inefficiently constructed—this is particularly true in fixed income. For example, a market-cap weighted credit index will be dominated by large issuers who are of low credit quality and are highly concentrated in a few sectors. A market–cap weighted commodities index will be heavily weighted to energy (oil and gas). These may make these indexes unsuitable particularly for

smaller accounts. If the Department directs people into these strategies, it could have significant negative consequences to investors.

Investment solutions should be designed to seek the optimal risk/return trade-offs that help investors improve their financial security and should use the full spectrum of tools available with outcomes, not just cost, in mind. Passive and smart beta are highly useful tools to be wielded in that process….but they are not a substitute for a well-diversified and appropriately constructed and managed portfolio. To limit one's investment universe to only one type of investment product could be a costly mistake over the long run.

In its commentary, the Department calls out passively managed target date funds as a potential solution. Passively managed target date funds are an oxymoron. Target date funds are portfolios that are designed based on active investment beliefs and inputs about the strategies and about investors …..particularly investors' time horizon to retirement and risk appetite along that glidepath. These are highly dynamic strategies. The decision of how to allocate among strategies and how to modify that over time inherently is an active decision.

Increasingly, there are tools that investors can use themselves or with the help of an experienced advisor to take advantage of the benefits of these products. An adaptive allocation model, for example, can help identify a person's needs, map them to an investment strategy, and adaptively re-allocate over time as variables in the market or their individual circumstances change. Firms that promote these technologies can help prudently select the firms that are likely to be successful at managing these tools and underlying products.

For these reasons, the Department should not seek to optimize cost and conflict mitigation at the expense of investment outcomes. This may invite a "race to the bottom" if the regulatory arbitrage is seen as significant….which it undoubtedly would be. We have seen this play out in the DC space all too often despite our best efforts to highlight the need for sponsors to follow a robust, prudent process …through which process they decide the balance of risk, return, and cost that is best suited for their needs which invariably will include some, but not exclusively, passive strategies.

***Closing Remarks***

One of the primary means of advancing retirement savings is through employers. Employers are the gateway to individuals embracing retirement savings. Since the Global Financial Crisis, however, employer sponsorship rates have decreased as have participation rates by employees. This is a highly concerning trend particularly among smaller employers where the trend is even more alarming. For employers with 1-24 employees, only about a quarter offer a plan. That number increases to the mid-40s for employers with 25-99 employees. The contribution rates for these plans, many of which may not have employer matching contributions, is significantly lower than with larger plans. We know, however, that there is a positive correlation between employers offering plans and employees saving for retirement. We also know that tax and other incentives can have a powerful effect on employees' decisions about whether to invest and how much. Lastly, we know that employers, as a fiduciary to their participants, offer a highly effective means of simplifying investment choices, administrative burdens, and cost for in a well-designed retirement plan. Employers also serve a key role in setting employees onto a path to be more effective *retirement consumers*. For these reasons, many of my comments today focused on the need for current regulatory efforts to facilitate and enhance the adoption and administration of plans (especially education and information) by employers of all sizes, but particularly smaller employers.

These suggestions are only a few of the many options available to the Department. Thank you again for the opportunity to share my views on this exciting and challenging new approach to improving retirement security. I look forward to your questions and the results of this collaborative process. If you have any questions after today, please feel free to contact me.