Statement of the Investment Company Institute
Hearing of the Joint Committee on Financial Services
The 187th General Court of the Commonwealth of Massachusetts

February 7, 2012

The Investment Company Institute\(^1\) is pleased to provide this written statement in connection with the Joint Committee on Financial Services’ hearing on Banking and Credit Unions (bill number H01194, an Act relative to universal voluntary retirement accounts). The Institute strongly supports efforts to promote retirement security for American workers and appreciates the interest of the legislature in ensuring that Massachusetts residents have sufficient resources for retirement. Americans currently have $17 trillion saved for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).\(^2\) About half of DC plan and IRA assets are invested in mutual funds, which makes the mutual fund community especially attuned to the needs of retirement savers. Massachusetts played a special role in the history of mutual funds when the Massachusetts Investors Trust was established in 1924 as the first modern day open-end mutual fund.\(^3\) We are proud of our shared history supporting the ability of current retirement savers to grow their retirement assets in a cost-effective manner by investing in diversified, professionally-managed, highly regulated portfolios.

House bill H01194, along with a similar bill (no. H03754, reported from the Massachusetts House Ways and Means Committee on October 17, 2011), would provide for the creation of a state-run retirement plan for private-sector workers in the Commonwealth. The bills are intended to fill a

\(^1\) The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.5 trillion and serve over 90 million shareholders.


\(^3\) See Investment Company Institute, 2011 Investment Company Fact Book, available at www.icifactbook.org, for a brief history of the mutual fund industry. ICI’s Annual Mutual Fund Shareholder Tracking Survey from May 2011 finds that an estimated 1.4 million households or 52 percent of the 2.6 million households in Massachusetts own at least one mutual fund.
perceived gap in retirement plan coverage for workers in the state employed by small businesses, or, in the case of H03754, non-profit organizations. An underlying assumption in the bills is that the private marketplace of retirement plan providers does not adequately serve the population of employers targeted in the bills. While increasing coverage levels for private-sector workers in Massachusetts is a worthy goal for the legislature, we believe having the state run a private-sector retirement plan as contemplated by these bills would not achieve the objective and would bring significant cost and administrative burden to the Massachusetts government and state taxpayers. In addition, the state would directly compete with businesses in the state that already provide retirement plan products and services to employers in Massachusetts. The Institute therefore opposes enactment of either H01194 or H03754.

I. Is There a Need for a State-Run Plan for the Private-Sector?

A. Options Available to the Private-Sector

Contrary to the bills’ assumption that employers are underserved by the existing retirement plan market, there actually are numerous options in terms of both plan types and plan providers. Small employers can select from a wide range of options including payroll-deduction IRAs, SEP IRAs, SIMPLE IRAs, safe-harbor 401(k) plans, and traditional 401(k) plans. A payroll-deduction IRA program has virtually no set-up costs beyond establishing a payroll feed. Non-profit organizations also are eligible to establish a 403(b) plan which operates similarly to a 401(k) plan, but with some important differences that can make it easier for the employer to maintain. Many financial services providers offer low-cost 401(k) and IRA-based plans to employers large and small. Furthermore, it is sometimes forgotten that generally any worker earning compensation can contribute to an IRA, and could set up an automatic payroll deduction plan if the employer’s payroll system accommodates it. Retirement savings opportunities—for those who value them—are not lacking.

B. Factors Influencing Plan Sponsorship

Proposals to allow the state governments to administer private-sector retirement plans are based on a fundamental misinterpretation of the empirical evidence. In this respect, proponents of extending the coverage of state-run retirement plans to private-sector employees generally point to statistics showing that small firms are much less likely to sponsor a retirement plan than are large firms. For example, in 2010, 69 percent of firms with 1,000 or more employees sponsored a retirement plan compared to 18 percent of employers with fewer than 10 employees. But drawing conclusions based on

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these data alone, without understanding why small firms are less likely to offer a retirement plan to their employees, is unlikely to lead policymakers to design a state-sponsored retirement system that will meet the desired goal of providing additional retirement security for employees of smaller firms. Indeed, widely accepted research shows that factors inherent in smaller employers, other than the size of the employer, have an important determinative impact on why fewer small firms offer a retirement plan.

We appreciate that it may be easy to readily conclude that the size of an employer alone could explain differences in plan coverage rates between large and small firms. One well-known difference between large firms and small firms is that, as a firm increases in size, it experiences economies of scale. That is, there are certain fixed costs incurred by a firm that do not change as it increases in size. As a firm increases in size, it theoretically is able to spread those costs out, so the fixed costs per unit of output declines. Those proposing state-run plans may surmise that the fixed costs of setting up and administering a plan are the major impediments deterring small employers from offering a plan.

Fixed costs are not the only difference, however, between small firms and large firms. A potentially more compelling explanation for the lower plan sponsorship rate among small firms is that small-firm employees systematically are less likely to desire to save for retirement in the current year. They place less value on employer-provided retirement benefits,\(^6\) and many of these employees may prefer cash wages to retirement benefits.

The question of whether high fixed costs or differences in workforce composition can best explain the observation that smaller firms are less likely to sponsor a retirement plan can be answered by testing other predictions associated with each explanation. For example, if the fixed costs associated with starting up and administering retirement plans are the primary barrier to small firms adopting a plan, then noticeable differences should exist in sponsorship rates by firm size even if firms are similar in other observable characteristics. In contrast, if the primary reason small firms are less likely to sponsor a plan is that small-firm employees place a lower value on benefits relative to cash compensation compared to larger-firm employees, the workforce composition of small firms should be noticeably different from that of large firms, and these differences should be consistent with small-firm employees having less desire to save for retirement in the current year.

The data on pension coverage suggest that the preferences of a firm’s workforce influence an employer’s decision to offer a retirement plan. Among all workers, younger and lower-wage workers are

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\(^6\) For firms where few employees desire to save for retirement, complying with nondiscrimination rules, rather than administrative costs, may be the largest barrier to adopting a plan. Nondiscrimination rules, designed to ensure that qualified plan benefits do not disproportionately accrue to a firm’s highly compensated employees, operate by linking the benefits received by high-paid workers to the benefits received by low-paid workers within a given firm. If few of a firm’s low-paid workers choose to contribute to a 401(k) plan, the amount high-paid employees can contribute is severely restricted. For these firms, the end result is that offering a 401(k) plan would provide little benefit to any employee.
much less likely to work for a firm that offers a retirement plan and household surveys show that younger and lower-income households are less likely to cite retirement as the primary reason they save. These households were more likely to be primarily focused on saving to fund education, to purchase a house, to fund other purchases, or to have cash on hand for an unexpected need. The tendency of younger workers to focus less on retirement savings is consistent with economic models of life-cycle consumption, which predict that most workers will delay saving for retirement until later in their working careers. In addition, Social Security benefits replace a higher percentage of pre-retirement earnings for individuals with low lifetime earnings, making lower earners less likely to desire to save for retirement at any given age.

Further examination of the data supports that differences in workforce composition are a primary cause of the lower rate at which small employers sponsor retirement plans. First, as a group, the characteristics of small firm employees differ substantially from the characteristics of large plan employees. Nevertheless, regardless of firm size, workers at firms that do not sponsor plans are younger, have lower earnings, have less formal education, and are more likely to work part-time or part-year. For example, in 2010, 25 percent of workers at small firms that sponsored plans had earnings of $25,000 or less, compared with 23 percent of employees at large firms that sponsor plans. Regardless of firm size, employees at firms that do not sponsor plans earn substantially less: 60 percent of employees at small firms that do not sponsor plans, and 53 percent of employees at large firms that do not sponsor plans, earn $25,000 or less.

Although administrative cost may influence an employer’s decision to offer a plan, it does not appear to be the primary driver of the low rate at which small firms offer retirement plans. Certainly there are fixed costs involved in administering individual accounts and complying with the complex regulations associated with a qualified plan. Research shows that, measured as a fraction of plan assets,

7 See Brady and Bogdan (2011), supra note 5, at p. 4.

8 Social Security replaces a much higher fraction of pre-retirement earnings for lower-income workers. For example, the first-year replacement rate (scheduled Social Security benefits as a percentage of average career earnings) for retired workers in the 1940–1949 birth cohort (individuals aged 61 to 70 in 2010) decreased as income increased. The median replacement rate for the lowest household lifetime earnings quintile was 71 percent; for the middle quintile, the median Social Security replacement rate was 43 percent; and for the highest quintile it was 30 percent. See Congressional Budget Office. 2011. CBO’s 2010 Long-Term Projections for Social Security: Additional Information (August). Washington, DC: Congressional Budget Office. Available at www.cbo.gov/fwpdocs/123xx/doc12375/08-05-Long-TermSocialSecurityProjections.pdf.

9 For a more complete discussion of the evidence, see Brady and Bogdan (2011), supra note 5.

10 In the discussion that follows, unless otherwise noted, small firms are defined as firms with fewer than 100 employees and large firms are defined as firms with 100 or more employees.
both the number of participants and the average account balance are key drivers of total administrative expenses.\textsuperscript{11} As discussed in more detail below, it is by no means clear that a state government would prove to be more efficient at administering a retirement plan than the many private-sector firms currently competing to provide services to small employers. That said, the extent to which lower administrative fees would increase sponsorship is uncertain. In this respect, data shows that plans \textit{are offered} by small firms that have workers similar to the typical large firm that offers a plan. Likewise, plans generally \textit{are not offered} by large firms which have workers similar to the typical small firm that does not offer a plan. Regulations require that qualified plans provide benefits to a substantial portion of a firm’s workforce. Regardless of administrative fees, it is unlikely that employers will find it cost effective to include retirement plan benefits in compensation if few of their workers value the benefits.

C. Assessing Coverage Rates

The success of private-sector retirement plans should not be judged by the percentage of workers with access to a plan at single point in time. Not all workers are focused on saving for retirement in the current year. As mentioned earlier, young workers may be saving primarily to pay for education, to purchase a home, or to use in case of emergency. Looking at the workforce overall, of those most likely to desire to save for retirement in the current year, three-quarters had access to a pension plan through their own employer or their spouse’s employer.\textsuperscript{12} Further, if one considers the benefits earned over an entire working career, 84 percent of households approaching retirement had assets in either a defined contribution plan or an IRA; had accrued benefits in a defined benefit plan; or both.\textsuperscript{13}

There is reason to believe that employees of non-profit organizations—the target population of H03754—have more access to retirement plans than most other private-sector employees, perhaps due to the composition of their workforce. According to a study on non-profit organizations in Massachusetts, 82% offer retirement benefits to their full-time employees.\textsuperscript{14} Broken down by size of employer, 73% of employers in the smallest group (less than 10 full-time employees), and over 90% of


\textsuperscript{12} See Brady and Bogdan (2011), \textit{supra} note 5.

\textsuperscript{13} ICI tabulation of the Federal Reserve Board’s 2007 Survey of Consumer Finances. Pre-retiree households are defined as households headed by a working individual age 55 to 65.

employers in each of the larger groups (10-49; 50-99; 100-249; and 250+ full-time employees), offer retirement benefits to their full-time employees. This suggests very high coverage rates among employees in the Massachusetts non-profit sector overall.

The available evidence does not indicate a compelling reason for state government entrance into this marketplace. A state-run retirement plan for private-sector employees would unfairly compete with private businesses in Massachusetts, using taxpayer dollars. As explained below, the potential cost savings for employers participating in such a plan is questionable. In addition, the costs to the state associated with setting up and maintaining a plan for some group of private employers likely would be much higher than anticipated.

II. Potential Costs of a State-Run Plan

Several other states have considered proposals to establish state-run plans for private-sector workers, whether 401(k), SIMPLE IRA, or other IRA-based arrangements, under the assumption that the state would have greater bargaining power and expertise, based upon its size and experience in providing retirement benefits for state employees, than the average private employer. The proposals presume that small private-sector employers would benefit from economies of scale under a state-wide program. Given the substantial costs that would be involved in establishing and administering a retirement plan for private-sector workers, including compliance with the Employee Retirement Income Security Act of 1974 (ERISA) (a federally-interpreted statute with complex rules), it is not surprising that to date, no state has moved forward to implement a state-run plan. On the other hand, IRA-based plans, which are not subject to the full range of requirements under ERISA, are already very easy for a single employer to set up and therefore call into question the justification for a state-sponsored option.

A. State as an ERISA Fiduciary

A state sponsoring a retirement plan for private-sector workers likely would become a fiduciary under ERISA, under a functional analysis of fiduciary status. If, as likely, the state and/or its employees select investments under the program, then the state and/or its employees could trigger

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15 California, Connecticut, Maryland, Michigan, Vermont, and Washington are among the states that have considered establishing some form of state-run plan for private-sector workers.

16 Under section 3(21)(A) of ERISA, a fiduciary is a “person,” which includes a number of different entities under the definition in section 3(9), but does not specifically mention government entities. Courts have considered ERISA fiduciary claims against government entities without specifically addressing whether a governmental entity is a “person” under ERISA. See Coleman v. Pension Benefit Guaranty Corporation, 2005 U.S. Dist. LEXIS 45021 (D.D.C. 2005), aff’d, 469 F.3d 1061 (D.C. Cir. 2006); Plummer v. Consolidated City of Indianapolis, 2004 U.S. Dist. LEXIS 20251 (S.D. Ind. 2004); Boivin v. US Airways, Inc., 297 F. Supp. 2d 110 (D.D.C. 2003).
fiduciary responsibilities by exercising “authority or control respecting management or disposition” of the plan’s assets.\textsuperscript{17} Although section 404(c) of ERISA provides protection from liability resulting from a plan participant’s exercise of control over the assets in his account, the Department of Labor takes the position that fiduciaries retain the responsibility to monitor the continued appropriateness of the investments available to participants.\textsuperscript{18} A fiduciary that breaches its responsibilities under ERISA is personally liable to make good to the plan any losses to the plan resulting from the breach.\textsuperscript{19} In addition, the Secretary of Labor may assess civil penalties in the case of a fiduciary breach.\textsuperscript{20}

There are other implications associated with becoming an ERISA fiduciary to consider, including prohibited transactions and bonding requirements. If the state or its employees serve as fiduciaries under ERISA, they must ensure that the plan does not enter into prohibited transactions (\textit{i.e.}, plans cannot enter into transactions with fiduciaries and other “parties in interest,” including employers, service providers and related entities).\textsuperscript{21} If a prohibited transaction occurs, the responsible fiduciary will have violated its fiduciary duty under ERISA and the “disqualified person” may be assessed an excise tax under the Internal Revenue Code (Code) based on the amount involved.\textsuperscript{22} If the plan covers hundreds or thousands of employers, avoiding prohibited transactions in the course of administering the program may be difficult.

Section 412 of ERISA requires plan fiduciaries and others who “handle” plan assets to be bonded. The bonding requirement may apply even if the entity’s activities do not constitute fiduciary duties under ERISA. “Handling” of assets occurs “whenever [a person’s] duties or activities with respect to given funds or other property are such that there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such person, acting either alone or in collusion with others.”\textsuperscript{23} In the event that state employees had access to ERISA plan assets, and such risks were present, ERISA bonding would be required.

\textsuperscript{17}ERISA § 3(21)(A)(i).
\textsuperscript{18}29 C.F.R. § 2550.404c-1(d)(2)(iv); 57 Fed. Reg. 46906, 46924 n. 27.
\textsuperscript{19}ERISA § 409.
\textsuperscript{20}ERISA § 502(7).
\textsuperscript{21}ERISA §§ 3(14) and 406.
\textsuperscript{22}Code § 4975.
\textsuperscript{23}29 C.F.R. § 2580.412-6(a)(1).
Although it is possible that potential fiduciary and prohibited transaction liability on the part of a state may be limited by the Eleventh Amendment and the concept of sovereign immunity, we question whether denying plan participants the fiduciary protections of ERISA would benefit private-sector workers in the state.

B. Administrative Duties Under ERISA

In addition to the fiduciary liability considerations discussed above, establishing an ERISA-covered plan requires a number of administrative actions. For example, ERISA requires the filing of an annual report to the Internal Revenue Service and the Department of Labor (Form 5500) and various disclosures to participants, including benefit statements, summary plan descriptions, summary annual reports, and summaries of material modifications. Also, in reviewing participant and beneficiary claims under the plan, plan administrators routinely make determinations that require interpretations of the written plan document and governing statutes and regulations. These interpretations may arise, for example, with respect to plan loans, hardship withdrawals, early retirement, spousal consent, and qualified domestic relations orders. Section 503 of ERISA requires that employee benefit plans must provide notice of any claim denial, as well as the opportunity for a “full and fair review” of any such denial. The state may not be in the best position to make these determinations, which are fact-specific and often require personal information. While the employer itself would have better access to the information, employer reluctance to take on these responsibilities may be an important factor in plan creation under current law. A state program under which employers retained these responsibilities therefore may not achieve the goal of increasing retirement plan coverage and savings.

C. Tax-Qualification Requirements

Depending on the type of plan, the applicable tax rules will vary. IRA-based plans would be much easier for a state to implement, but still raise concerns about whether state involvement would be appropriate.

1. Multiple Employer Qualified Plan

Both bills acknowledge that the state may need approval from federal regulators to offer the types of arrangements contemplated. Particularly if the state wanted to offer a qualified plan under section 401(a) of the Code (e.g., a 401(k) plan), as is contemplated by H03754, obtaining necessary approvals from federal regulators would be just the first of many hurdles. The specific rules for “multiple employer plans” (a single plan consisting of multiple unrelated employers) could make this structure unwieldy for a diverse state-wide group of unrelated employers. As explained below, the rules

24 See ERISA §§ 101 through 105.
under Code section 413(c) require aggregation of all participating employers for some purposes and separate treatment for others. Regardless, one of the main obstacles in maintaining a multiple employer plan is that the failure by one employer maintaining the plan (or the plan itself) to satisfy a qualification requirement is considered a qualification failure for the entire multiple employer plan.25

The requirement for certain purposes to treat all participating employers in a multiple employer plan as one employer could involve significant recordkeeping obligations. First, to the extent that the plan included minimum participation rules, section 413(c)(1) would require that the section 410(a) participation rules apply as if all employees of each of the employers who maintained the plan were employed by a single employer. Similar aggregation would apply for purposes of vesting credit26 and compensation and deferral limits under sections 415 and 402(g). Each of these rules would require recordkeeping, both on the part of the employers and the state, to track employees moving among employers utilizing the plan.

Other tax-qualification rules must be satisfied by each participating employer separately, such as nondiscrimination testing under sections 401(a)(4), 401(k) and 401(m) and coverage testing under section 410(b).27 Top-heavy requirements also apply separately to each employer.28 Thus, the employer under a multiple employer plan would retain much of the compliance responsibility that would apply under a single employer plan. Overall, the multiple employer plan structure could add more complexity as compared to a single-employer plan, and therefore could further discourage employers from participating.

2. SIMPLE IRA Plan

H01194 specifically contemplates a two-tiered system with one tier being a SIMPLE IRA-type program (or other IRS-approved plan). Under a SIMPLE IRA, an eligible employer can allow employees to make salary deferrals to IRAs without having to file Form 5500 or take on extensive administrative responsibilities. The employer has only limited fiduciary duties with respect to SIMPLE retirement accounts.29


26 Code § 413(c)(3).

27 Treas. Reg. §§ 1.401(a)(4)-1(c)(4); 1.401(k)-1(b)(4)(iv); 1.401(m)-1(b)(4)(iv); and 1.413-2(a)(3)(ii).


29 See ERISA § 404(c)(2).
The IRS administers a prototype program for SIMPLE IRAs, but limits the sponsors to trade associations, banks, credit unions, investment companies (and their investment advisers and principal underwriters), or “a person who under regulations may act as a trustee or custodian of an IRA.”\(^{30}\) Presumably, a government entity wishing to sponsor a SIMPLE IRA prototype plan would need to seek approval from the IRS to be a non-bank trustee. It is unclear whether current regulations would allow this.

Regardless of these considerations, the fact is that it already is very easy and inexpensive for a small employer to set up and administer a SIMPLE IRA plan. The major responsibility associated with SIMPLE IRAs, which likely accounts for relatively low take up rates, is the statutorily-required annual employer contribution. Employers sponsoring SIMPLE IRAs must commit to either match 100 percent of an employee’s contributions up to the first three percent of compensation, or contribute two percent of each eligible employee’s compensation.\(^{31}\) Participating employers would continue to face this economic commitment in a SIMPLE IRA plan established by the state. Thus is it unclear what efficiencies would be gained by a state-run plan of this nature.

D. Payroll Deduction IRAs

The second component of the program outlined in H01194 would be “workplace based individual retirement accounts open to all workers.” Payroll deduction IRA programs allow employees to make regular contributions to a retirement savings account without requiring a “full-blown” qualified plan, and without triggering employer fiduciary responsibility under ERISA. The regulations under ERISA provide for a safe harbor under which a payroll deduction IRA program will not be considered an employee benefit plan if (1) no contributions are made by the employer; (2) participation is completely voluntary for employees; (3) the sole involvement of the employer is to permit the sponsor to publicize the program to employees (without endorsement by the employer), to collect contributions through payroll deductions and to remit them to the sponsor; and (4) the employer receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions.\(^{32}\) A 1999 Department of Labor interpretive bulletin further clarifies the steps that employers may take without “endorsing” the program, including limiting the number of IRA sponsors offered under the program. An employer


\(^{31}\) Code § 408(p)(2).

\(^{32}\) 29 C.F.R. § 2510.3-2(d).
cannot take advantage of the safe harbor, however, if it exercises any influence over the investments made or permitted by the IRA sponsor.\textsuperscript{33}

H01194 appears to contemplate the state playing a role in the selection of the investments available to participants. As noted above, an employer wishing to avoid ERISA coverage of a payroll deduction IRA program cannot attempt to influence the financial institution’s selection of options. If the state were deemed an agent of the employer in its selection of investment options, this activity might result in ERISA coverage of the state payroll deduction IRA program.

Again, it is unclear what benefit a state-sponsored payroll-deduction IRA plan would provide, given the ease with which an employer can set up this type of program currently, and it may in fact be more complicated for the state to play a role in sponsoring it. If the payroll deduction IRA program established by the state fell under ERISA, the fiduciary and other ERISA issues described earlier could apply to the program. In addition, any state involvement in the employee benefit plan area raises potential Federal preemption issues.\textsuperscript{34}

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In conclusion, we urge the legislature to undertake a comprehensive examination of the characteristics of the small employer workforce that influence the decision to offer retirement plans, as well as the true costs and benefits that would be involved in establishing and maintaining a retirement plan for private-sector employees. As with the many other states that have considered this type of proposal in recent years, the examination is likely to find that the costs will outweigh any potential benefits. Retirement plan providers in Massachusetts, including many Institute members, currently offer cost effective solutions to small employers and non-profit organizations, as well as to individuals directly through IRAs. It is important to note that factors in addition to administrative costs, such as lack of demand from employees, may influence whether an employer chooses to make use of the many solutions available.

\textsuperscript{33} 29 C.F.R. § 2509.99-1.

\textsuperscript{34} Section 514 of ERISA generally provides that Title I of ERISA supersedes any state laws insofar as they relate to any employee benefit plan. The exemption for governmental plans would not apply because the programs contemplated by the bills would cover private-sector employees.