

Comment Letter on SEC Regulation of Retirement Plan Investments, May 1996

April 29, 1996

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Comment Letter Regarding Study and Report on Protections for Senior Citizens and Qualified Retirement;
Release No. 34-37009; File No. S7-8-96

Dear Mr. Katz:

In response to the Securities and Exchange Commission's request for comments made pursuant to the Private Securities Litigation Reform Act of 1995 in the above-referenced Release, the Investment Company Institute submits the following comments. As directed by the Act, the Commission seeks public comment regarding (1) the changing role of senior citizens and qualified retirement plans as investors in the financial markets and (2) the special needs of these investors and concomitant changes to the securities laws that may be necessary to adequately address those needs. It also seeks comment on the need for additional protections for these investors against securities fraud, on whether or not these investors have been adversely impacted by abusive or unnecessary securities fraud litigation and on recommended changes to securities laws and regulations that would protect these investors against such fraud and litigation.

Institute members play an increasingly active role in the retirement plan market. Mutual funds are a popular investment vehicle for retirement plan investors. Moreover, many funds or their affiliates offer recordkeeping and other administrative services to these plans. The Institute therefore is pleased to offer its recommendations to the Commission on these matters.

Our comments focus on the enormous changes in the retirement plan market and the need for our securities laws to reflect those changes to assure that all individuals that make investment decisions—including individuals directing the investment of their retirement plan savings—are adequately informed and protected. More particularly, the Institute recommends repeal of the statutory exemptions from the securities laws for bank collective funds and insurance company separate accounts in which pension plan assets are invested.

Background

In 1970, Congress amended the Investment Company Act of 1940 to exempt from the definition of an investment company any bank collective fund that consists solely of the assets of qualified retirement plans. The same provision exempts insurance company separate accounts the assets of which are derived solely from contributions under such plans. 15 U.S.C. Section 80a-3(c)(11). At the same time, Congress also exempted interests in such bank collective funds and insurance company separate accounts from the registration requirements of the Securities Act of 1933, 15 U.S.C. Section 77c(a)(2).

The statutory exemptions were based on two grounds: (1) that bank collective funds were regulated under an alternative regulatory scheme embodied in federal banking regulations administered by the Office of the Comptroller of the Currency (OCC), and, more significantly, (2) that banks and insurance companies did not sell interests in such funds to the general public, but instead sold them only to sophisticated corporate employers who had the ability to obtain investment information concerning the funds on a voluntary basis and who had the investment expertise to evaluate the information so obtained. At that time, most retirement plans were defined benefit plans, which were designed to provide an employee with a specified benefit upon retirement, with the employer obligated to provide the benefit bearing the risk flowing from the performance of the plan's investments. There is substantial doubt that this rationale sufficed even in 1970 to justify the virtually wholesale exemption of bank collective funds and insurance company separate

accounts for corporate retirement plans from the securities laws. Today, it is absolutely clear that the exception has no such justification.

In 1970, neither the individual retirement account (IRA) nor cash or deferred arrangement (e.g., section 401(k) plans) existed, and the Keogh plan was a relatively new retirement vehicle. There was not yet a federal retirement income security law to drive the formation of plan designs, which would result in shifting investment decision making and risk-bearing to plan participants. Nor was the technology yet available to make such participant-directed plans feasible. Indeed, in 1970, plan participants typically were not investors, and the corporate plan sponsor, sophisticated or not, in its capacity as sponsor, fiduciary, and to some extent, guarantor, served as an important intermediary between the participant and plan investment media.

Today, in stark contrast, interests in bank and insurance company investment pools are being sold to individual employees to fund their participant-directed defined contribution plans, plans in which employees, not the employer or an intermediary fiduciary, make the investment decisions and bear the investment risks. Thus, exemptions that may have made some policy sense twenty-six years ago make no sense now. The underlying rationale for the exemptions has completely eroded. As a result there are a significant number — tens of millions — of individual retirement plan investors who do not receive the protections of the securities laws provided to other individual investors in the securities markets.

The Shift to Participant-Directed Defined Contribution Plans

As the Commission staff noted in its landmark 1992 report *Protecting Investors: A Half Century of Investment Company Regulation*, the most significant change in the retirement plan market has been the shift from defined benefit plans to defined contribution plans — especially the enormous growth and popularity of participant-directed defined contribution plans. Participant-directed defined contribution plans permit participants to act much like other investors. To address this shift, the Commission staff recommended, as we do here, that the exemptions from the securities laws for interests in bank collective funds and insurance company separate accounts in which participant-directed defined contribution plans invest be repealed and that a prospectus delivery requirement be instituted for the underlying investment vehicles for employees directing plan investments. In addition to these amendments, the Institute strongly recommends repealing the exemptions from the Investment Company Act for these pooled investment vehicles.

Since the Commission staff documented the shift to participant-directed contribution plans, it has, in fact, continued to accelerate. With the institution of recent technological advances, plan sponsors now design their participant-directed plans to offer a vast array of investments to individual participants at little cost. Typically, participants can choose from five to ten investment options, and often many more. Moreover, participants often may make investment decisions and buy and sell on a daily basis — with no ERISA fiduciary intervention, knowledge or assistance. Such plan participants are just like individual retail investors — with one distinction. They do not obtain all of the disclosures and protections that the securities laws provide to the retail investor. Quite simply, the need for reform has become more urgent.

ERISA Section 404(c) Regulations and Continued Inadequacy of Disclosure

Shortly after the Commission staff issued its report in 1992, the Department of Labor (DOL) issued regulations under section 404(c) of ERISA concerning participant-directed defined contribution plans. The regulation provides that certain limited items of information about the investment options be furnished to plan participants in order for the employer to be able to limit significantly its fiduciary responsibility with respect to such investments.

The Institute does not believe the DOL regulations provide protections equivalent to those that would be provided if exemptions from the securities laws were repealed. The reasons include (1) the regulations do not apply to retirement plans not covered by ERISA (e.g., governmental plans); (2) the regulations are not mandatory, but are only an optional safe harbor for employers; (3) the disclosures required actually to be furnished to employees are not as extensive as those required under SEC standards, and in fact, much information, such as that concerning the annual operating expenses of the available investment options need only be provided to the employee upon request; and (4) the disclosures, unlike mutual fund prospectuses, are not subject to review by a governmental agency and are not required to be presented in a standardized format. The limited scope of the DOL's regulation underscores the need for legislative reform to require that all pooled investment products sold to plan participants register with the SEC and provide full and fair disclosure to every participant responsible for investing his or her own retirement savings.

More generally, the securities laws, not ERISA, are the more appropriate regulatory vehicles for assuring the adequacy of financial disclosure. ERISA speaks to the sponsor-fiduciary-participant relationship and requires information be provided regarding plan design and one's right to benefits. It does not address the relationship between plan participants and investment vehicles, because (but for the exception of section 404(c)-type plans) the statute anticipated a fiduciary, not plan participants, making the plan's investment decisions and implicitly left regulation of that relationship to the securities regulators.

The Profile Prospectus

In recognition that investors urgently need clear, readable and digestible financial information, the Commission is in the process of testing a new, simplified disclosure document—the profile prospectus. Development of this document may be the most significant regulatory initiative in recent years—one that will directly and affirmatively assist millions of individual investors. In fact, in a recent no-action letter the Commission staff already has permitted the use of a summary disclosure document similar to the profile for mutual funds marketed to retirement plans. This type of disclosure document is ideally suited for use by all pooled investment products marketed to retirement plans.

Recommendations

The Institute believes that exemptions created from the securities laws in 1970 no longer reflect the reality of the retirement plan market. As a result, there is a disturbing breach in our regulatory regime that leaves retirement plan participants vulnerable and raises significant public policy concerns. We therefore recommend that the Commission seek legislation amending (1) Section 3(a)(2) of Securities Act of 1933 to remove the current exemption from registration and prospectus delivery requirements for interests in bank collective funds and insurance company separate accounts sold to retirement plans, and (2) Section 3(c)(11) of the Investment Company Act of 1940 to treat these pooled investment vehicles as "investment companies" subject to the protections of that law. We also recommend that the Commission adopt the profile prospectus as a stand-alone disclosure document.

We appreciate the opportunity to provide these comments. The Institute staff would be glad to provide additional information on this issue.

Sincerely,

Paul Schott Stevens
Senior Vice President
General Counsel

cc: The Honorable Arthur Levitt, Jr.
Chairman, U.S. Securities and Exchange Commission

The Honorable Steven M.H. Wallman
Commissioner, U.S. Securities and Exchange Commission

The Honorable Norman S. Johnson
Commissioner, U.S. Securities and Exchange Commission

The Honorable Isaac C. Hunt, Jr.
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