Chapter 3

Pooled Investment Vehicles for Employee Benefit Plan Assets

I. Introduction and Summary of Recommendations

Over 50 million Americans have more than two trillion dollars invested in and through their employers' employee benefit plans. The assets of employee benefit plans are frequently invested in bank collective trust funds and insurance company separate accounts in which a bank or insurance company pools the assets of two or more plans to manage the assets more efficiently and to diversify the plans' investments more effectively. Although those pooled investment vehicles are functionally similar to registered investment companies, they are generally exempted from most provisions of the federal securities laws:[1] The Division has examined these exemptions in light of numerous business and legal changes that have occurred in the pension industry in recent years and has concluded that certain of the exemptions are no longer desirable as a policy matter.

When the securities laws exceptions for pooled investment vehicles were enacted, pension plans were predominantly "defined benefit plans" offered by large and generally sophisticated employers. Employers offering defined benefit plans promise the employees a specific benefit payable upon retirement, choose the plans' investments, and bear any investment risk associated with the plans. Further, the Pension Benefit Guaranty Corporation insures defined benefit plans.[2] The Employee Retirement Income Security Act of 1974 ("ERISA")[3] is the primary law governing the activities of all retirement plans and their sponsors. ERISA

'Section 3(a)(2) of the Securities Act of 1933 ("Securities Act") generally excepts from registration the securities issued by collective trust funds and separate accounts. Securities Act of 1933, 15 U.S.C. § 77c(a)(2). Section 3(a)(12) of the Securities Exchange Act of 1934 ("Exchange Act") exempts the securities issued by these vehicles from the registration requirements of that Act. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(12). Section 3(c)(11) of the Investment Company Act of 1940 ("Investment Company Act") excludes these pooled investment vehicles from regulation under the Investment Company Act. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(11).

[2]The PBGC safety net, alone, may not provide sufficient protection to defined benefit plan participants. *See* SUBCOMM. ON OVERSIGHT OF HOUSE COMM. ON WAYS AND MEANS, 102d Cong., 1st Sess., PENSION BENEFIT GUARANTY CORPORATIONS PROGRAM TO IDENTIFY, COLLECT, AND ACCOUNT FOR PREMIUM PAYMENTS 2-6 (Comm. Print 1991); Albert B. Crenshaw, *Pension Agency's Books in Disarray, Study Finds*, WASH. POST, Nov. 8, 1991, at G1.

[3]Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001.

subjects plan sponsors to a range of fiduciary duties regarding the choice of plan investments depending on the type of pension plan. With respect to defined benefit plans, the plan fiduciaries have duties to choose prudently and monitor the plans' *investments.*

During the last two decades, many employers, particularly small and medium-sized employers, have offered their employees "defined contribution plans." In recent years the creation of these plans has far outpaced the creation of defined benefit plans![4] Defined contribution plans differ from defined benefit plans in several respects. In a defined contribution plan, an employer promises that it will set aside a specific contribution in an individual account for each employee's benefit and that each employee will receive a benefit equal to the amounts contributed to his or her account plus or minus the account's investment gains or losses. Many of these plans place the responsibility on employee-participants to direct the investment of their individual accounts?[5] By doing so, the investment risk associated with the investment of a pension plan falls on the employee. Fiduciaries of a participant-directed defined contribution plan have a duty to choose prudently and monitor the *investment options* available to participants, but the plan fiduciaries have no obligation to assure that participants choose suitable investments from the available options. Finally, the employee in a participant-directed defined contribution plan has no PBGC safety-net undergirding his or her choices.

While **ERISA** governs the activities of retirement plans, its disclosure regulations focus on disclosure about the plan itself and not on the investments that underlie the plans. The limited disclosure provided to plan participants about the underlying investments may have been appropriate when the employer made the investment decision and bore the investment risk. With the growth of participant-directed defined contribution plans, however, where the investment risk falls on the employee, plan participants need the same information as any other individual who invests in securities, and the focus of the securities laws needs to shift from the sponsor/employer to the participant/employee. This is

[4]*See* **EMPLOYEE BENEFITS RESEARCH INSTITUTE, EBRI ISSUE BRIEF 8, Table 3 (Oct. 1991) [hereinafter EBRI]; Phyllis Feinberg,** *Changing Times for Pension Funds in the 1990s,* **BARRON'S, Nov. 18,1991, at 34.**

[5]**Craig S. Smith,** *Investor Control of Retirement Funds is Rising,* Wall **St.** J., Jan. **31, 1992, at B4c.**

particularly so where the plan fiduciaries do not have a fiduciary obligation with respect to a participant's investment choices![6]

The Division has reconsidered the securities laws exemptions from two perspectives: whether employees should receive better disclosure regarding their investments, and whether the pooled investment vehicles themselves should be registered under the Investment Company Act. The Division recommends that the Commission send to Congress legislation that would remove the current exemption from registration in section 3(a)(2) of the Securities Act of 1933 ("Securities Act") for interests in pooled investment vehicles for *participant-directed defined contribution plans.* Further, the legislation would amend the federal securities laws to require the delivery of prospectuses for the underlying investment vehicles to plan participants who direct their investments. We also recommend legislation that would amend the Securities Exchange Act of 1934 ("Exchange Act") to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants. Finally, we recommend that the rules under the Investment Company Act be amended to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants. Without these changes, plan participants will increasingly be forced to fend for themselves and make uninformed investment decisions, with the result that they may invest imprudently or too conservatively, fail to diversify their investments, and retire with inadequate assets.

The Division recommends retaining the current Securities Act exemption for interests in pooled investment vehicles for *defined benefit plans* and *defined contribution plans that do not provide* for *participant direction.* Since the fiduciaries of a defined benefit plan are subject to all of the fiduciary duties and liabilities under ERISA and the plans are PBGC insured, we do not believe that the additional protections of the securities laws are necessary.

Despite the general appeal of functional regulation, we do not recommend that bank collective trust funds or insurance company separate accounts containing retirement plan assets be required to register under the Investment

[6]*See* **29 U.S.C. § 1104(c); Participant Directed Individual Account Plans, 56 FR 10724 (1991) (reproposing 29 C.F.R. § 2550.404c-1).**

Company Act of 1940 ("Investment Company Act")? Participants in plans that invest in bank collective trust funds or insurance company separate accounts are protected by other regulatory schemes, such as ERISA, banking regulations (regulation 9, the regulation of the Comptroller of the Currency governing the fiduciary powers of national banks), and state insurance laws,[8] diminishing the need for regulation under the Investment Company Act. Although these regulatory schemes differ, the differences do not justify altering the *status* quo and the additional costs that would result from applying the Investment Company Act to these investment vehicles.

This chapter reviews the historical justifications for the exemption of pooled investment vehicles from the securities laws and discusses recent changes in the nature of employee benefit plans (see Chronology, Appendix A). It then compares the disclosure and other requirements of the three federal regulatory schemes under which registered investment companies, bank collective trust funds, and pooled insurance company separate accounts currently operate and discusses the reasons for the Division's recommendations.

[7] In connection with its proposal to modernize the financial system, the Department of the Treasury has recommended regulating banks' pooled investment activities in a manner more similar to investment companies. *See* U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM 59 (1991). We believe that we can accomplish the goals of functional regulation at the lowest cost by requiring interests in collective trust funds and separate accounts containing assets of participant-directed defined contribution plans to be registered under the Securities Act and by requiring these collective trust funds and separate accounts to provide prospectuses and shareholder reports to plan participants.

[8] Insurance company separate accounts are established under state law. Unless excepted by the pension plan provisions of the securities laws, separate accounts that fund variable annuities or variable life insurance are subject to the federal securities laws and thus are regulated by the Commission. While this chapter does not attempt to survey state insurance law, states provide an additional layer of protection to plan participants. For example, most states require insurance companies to insulate separate account assets from liabilities arising out of other business the company may conduct. State laws also may prescribe diversification requirements and sometimes prohibit transactions between the separate account and the insurance company. *See generally* Stephen E. Roth, Susan S. Krawczyk, & David S. Goldstein, *Reorganizing Insurance Company Separate Accounts under Federal Securities Laws*, 46 BUS. LAW. 537, 542-45 (1991).

11. Treatment of Pooled Investment Vehicles Under the Federal Securities Laws

A. Historical Treatment of Bank Collective Trust Funds

As enacted, the Investment Company Act provided that any employees' pension, stock bonus, or profit-sharing trust which met the conditions of section 165 (now section 401) of the Internal Revenue Code ("Code") was not an "investment company."[9] There is no legislative history for this exclusion (originally section 3(c)(13)). The Code required, and requires now, that a pension trust be administered for the exclusive benefit of the participants, and generally that the plan assets not revert to the employer. The Code also prohibits transactions between the employer and the trust. Given these protections, the employer's incentive would be to maximize the benefits to employees and, especially in the case of defined benefit plans, minimize administrative costs. Thus, Investment Company Act protection was apparently considered unnecessary?' The Investment Company Act did not provide an exception for pooled investment vehicles in which pension plans were invested.

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[9]Investment Company Act of 1940, ch. 686, § 3(c)(13), 54 Stat. 789,799 (1940). The provision was redesignated as section 3(c)(11) in 1970. Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 (1970) [hereinafter 1970 Amendments] (codified as amended at 15 U.S.C. § 80a-3(c)(11)).

Section 165 of the Code exempted from federal income tax a trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of its employees if contributions were made to the trust by such employer, or employees or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, and if under the trust instrument it was impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of his employees. Revenue Act of 1938, ch. 289, § 165, 52 Stat. 447,518 (1938) (codified as amended at 26 U.S.C. § 401).

Section 401 replaced section 165 when the Internal Revenue Code of 1954 was enacted. Internal Revenue Code of 1954, ch. 736, § 401, 68A Stat. 3,134 (1954) (codified as amended at 26 U.S.C. § 401). Section 401 sets forth tax qualification requirements similar to those described above, and includes certain non-discrimination provisions as well as other restrictions.

[10]*See* Robert H. Mundheim & Gordon D. Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-sharing Plans,* 29 L. & CONTEMP. PROBS. 795,815 (1964) [hereinafter Mundheim & Henderson]. Corporate plans that did not meet the conditions for qualification under section 165 could apply for an order exempting them from the Investment Company Act under section 6(b) of the Investment Company Act, a provision allowing the Commission to exempt employees' securities companies. 15 U.S.C. § 80a-6(b). *See* Mundheim & Henderson, *supra,* at 815-16.

The Securities Act had no parallel exemption for *interests* in employee benefit plans or pooled investment vehicles. The Commission's staff early on expressed the view that employee interests in pension and profit-sharing plans generally are securities, but did not require the interests in the plans to be registered under the Securities Act unless the plan provided for the purchase of the employer's stock?' The staff's early view was premised on several theories: (1) if there are no employee contributions, an interest in an employee benefit plan is the equivalent of a gift and therefore does not involve a "sale;"[12] (2) if employee contributions are involuntary, there is no sale because there is no investment decision;[13] and (3) voluntary contributions are permissible so long as the contributions are not used to purchase the employer's stock (*i.e.*, the corporation does not use an employee benefit plan as an outlet for its own stock).[14]

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[11] *See* Ops. SEC Ass't Gen. Couns., [1941-1944 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 75,195 [hereinafter 1941 Opinion1 (discussing the Assistant General Counsel's opinions with respect to the presence of a "security" and a "sale" in connection with an interest in certain employee benefit plans). The Assistant General Counsel also noted that exemptions from registration were available to plans that invested in employer stock under sections 3(a)(1), 3(a)(8), 3(a)(11), 3(b), and 4(1) of the Securities Act. *Id.*

Commissioner Purcell testified that the Commission had always considered pension plans that involved the sale of a security to be subject to the Securities Act. Commissioner Purcell noted that noncontributory and involuntary plans would not be subject to the Securities Act. *See Proposed Amendments to Securities Act of* 1933 *and the Securities Exchange Act of* 1934: *Hearings Before the Comm. on Interstate and Foreign Commerce, House of Representatives,* 77th Cong., 1st Sess. 892-97 (1941).

[12] For a discussion of the "no sale" theory and the view that there is a "sale" for value "because the employee can be deemed to have received constructively the appropriate amount of wages and tendered them back," see Martin E. Lybecker, *Bank-Sponsored Investment Management Services: A Legal History and Statutory Interpretive Analysis - Part 2,* 5 SEC. REG. L. J. 195, 227-8 (1977) [hereinafter Lybecker]. *See also* Mundheim & Henderson, *supra* note 10, at 807 n.39.

[13] Mundheim & Henderson note that the Commission's "no-sale" theory here was "not premised on the theory that the interest in the pension plan was disposed of without value or consideration in the common law sense. . . . Rather, the Commission's view is premised on the ground that there is no offer or sale in the securities laws sense because 'there is no element of volition on the part of the employees whether or not to participate and make contributions.'" Mundheim & Henderson, *supra* note 10, at 807 (quoting 1941 Opinion, *supra* note 11).

[14] One basis for the staff's view was a concern that the burden of preparing a registration statement in connection with the operation of a pension plan might result in many employers not allowing employees to make contributions toward their retirement. However, requiring registration where employer stock is purchased is justified because the employer would have a direct financial interest in the solicitation of the employees' contributions. Where employer stock is among the investment options, "it is not unfair to make [the employer] assume the same burdens which corporations typically assume when they go to the public for financing." Id. at (continued..)

Before World War 11, most retirement plans were defined benefit plans[15] sponsored by large corporate employers. Banks did not need to pool the assets of these large plans for efficient management.[16] Banking regulations governing collective investment funds, then administered by the Federal Reserve Board, permitted the use of common trust funds to pool moneys received solely for bona fide fiduciary purposes, but did not separately authorize collective trust funds for employee benefit plans.[17]

The number of corporate employee benefit plans increased rapidly after World War II,[18] and some banks pooled the assets of small employee benefit plans with their common trust funds. Apparently in response, the Federal Reserve Board amended its regulations to permit banks to invest the assets of pension, profit-sharing, and stock bonus plans collectively, provided that each

[14](...continued)
809-10. *Cf.* SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (interpreting the nonpublic offering exemption under the Securities Act in the context of an offer of the employer's stock to a large number of employees through an employees' stock investment plan); and Form S-8, Securities Act Release No. 6867 (June 6, 1990), 55 FR 23925 (registration statement for employee benefit plans under which employees are permitted to invest their own contributions in employer stock).

[15]ROBERT L. CLARK & ANN A. MCDERMED, THE CHOICE OF PENSION PLANS IN A CHANGING REGULATORY ENVIRONMENT 64/65/72 (1990) [hereinafter CLARK & MCDERMED].

[16]See Mundheim & Henderson, supra note 10, at 821.

[17]*See* Trust Powers of National Banks, 2 FR 2976 (1937) (adoption of amendments to regulation F by Federal Reserve Board); see also 24 Fed. Reserve Bull. 4-5 (1938) (common trust funds to be operated strictly for fiduciary purposes). Common trust funds allow banks to conveniently administer assets held by the bank for true fiduciary purposes and are excepted from the definition of investment company by section 3(c)(3) of the Investment Company Act. 15 U.S.C. § 80a-3(c)(3).

[18]A Senate subcommittee report, summarizing hearings and studies conducted by the subcommittee and its staff, attributes postwar growth in employee benefit plans to:

> (1) High corporate taxes during and since World War II, coupled with the allowance of tax deductions for contributions to these programs, thus permitting their establishment at a low net cost; (2) Wage stabilization programs during and since World War II and the Korean conflict, which froze wage rates but permitted increased employee compensation in the form of these 'fringe' benefits; (3) Court decisions in the years 1948-50 which made welfare and pension matters a bargainable issue; and (4) Since 1948, the drive of labor unions to obtain welfare and pension programs. Labor spokesmen state that another reason for the development of these programs has been the inadequacy of benefits under the governmental programs.

SENATE COMM. ON LABOR AND PUBLIC WELFARE, SUBCOMM. ON WELFARE AND PENSION FUNDS, WELFARE AND PENSION PLANS INVESTIGATION, S. REP. NO. 1734, 84th Cong., 2d Sess. 12 (1956).

such plan was exempt from federal income taxes and the collective investment was specifically authorized by the trust instrument underlying the plan or court order.[19] Also apparently in response, and recognizing that many employee benefit plans were too small to permit satisfactory diversification of their investments, the IRS ruled that a qualified plan may pool its funds with the funds of other qualified plans in a group trust without losing its "qualified" status under section 401 of the Code.[20] Under those circumstances, the group trust itself would be a qualified trust under section 401.[21]

The Commission's view at this time regarding the status of collective trust funds under the securities laws was unclear. By the early 1960's, the Commission interpreted the exclusion provided by section 3(c)(13) of the Investment Company Act to apply to collective trust funds.[22] Later in the decade, however, the staff, by "no-action" letter, took the position that interests in a collective trust fund would have to be registered under the Securities Act if the participating plans were voluntary and contributory.[23]

In 1962, to provide tax incentives and benefits similar to those available to corporate plans, Congress amended section 401 of the Internal Revenue Code to establish H.R. 10 ("Keogh') plans for self-employed persons and their

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[19] *See* Collective Investment Trust Funds, **20** FR **3305 (1955).** The Federal Reserve Board did not extend to collective investment funds the restrictions in regulation F that were "designed to prevent the use of common trust funds primarily as investment vehicles." *Id.;* William P. Wade, *Bank-Sponsored Collective Investment Funds: An Analysis of Applicable Federal Banking and Securities Laws,* **35** Bus. LAW. **361,365-366 (1980).** Regulation F required common trust funds to be operated only for "true fiduciary purposes," not advertised to the public as investment vehicles. Id. at **366** n.30; 42 Fed. Reserve Bull. 228 **(1956).** *See also* Lybecker, *supra* note **12,** at **246.**

[20] Rev. Rul. **56-267,1956-1** C.B. 206, *restated in* Rev. Rul. **81-100, 1981-1** C.B. **326.**

[21] *Id.*

[22] *See Common Trust Funds - Overlapping Responsibility and Conflict in Regulation: Hearings Before a Subcomm. of the House Comm. on Government Operations,* 88th Cong., 1st Sess. **7 (1963)** [hereinafter *Fascell Hearings]* (statement of William L. Cary, Chairman, SEC). Wade asserts that "the justification underlying this interpretation apparently emanated from policy considerations relating to encouragement of pension plan growth, reliance on the ability of corporate plan sponsors to fend for themselves in the market place, and avoidance of overlapping jurisdiction between bank regulators and the SEC." Wade, *supra* note **19,** at **377.**

[23] *See* Central Bank of Montana (pub. avail. pending) (response dated Apr. **26, 1968);** Safe Deposit Bank and Trust Company (pub. avail. pending) (response dated Mar. **5, 1968);** Birmingham Trust National Bank Self-Employed Retirement Trust (pub. avail. pending) (response dated Mar. **4,** 1968).

employees.[24] Keogh plans are generally so small that pooling is necessary for their efficient management.

The Commission construed section 3(c)(13) to include Keogh plans and collective trust funds containing Keogh plan assets.[25] However, the Commission took a different view on registration of the *interests* in pooled investment vehicles that included Keogh plan assets under the Securities Act, because these interests would be offered to relatively unsophisticated investors who would be unable to rely on the individualized, personal contact generally viewed as an integral part of traditional fiduciary services.[26] The Comptroller of the Currency[27] opposed registration of interests in bank-sponsored pooled investment funds for Keogh plans, asserting that the exemption in section 3(a)(2) of the Securities Act for securities issued by banks applied to such interests[28] and that the advertising

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[24]Self Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809 (1962) (codified as amended at 26 U.S.C. § 401(c)).

[25]The status of Keogh plans under the Investment Company Act was ambiguous, turning on a convoluted and technical analysis. It was not clear whether the exclusion of section 3(c)(13) applied to them. Section 3(c)(13) referred to plans qualified under section 165 of the Internal Revenue Code of 1939 "as amended," not section 401 of the Internal Revenue Code of 1954 "as amended." Since section 401 covered the same types of *corporate* plans covered by section 165 of the 1939 Code, it seemed appropriate to treat section 3(c)(13) as though it referred to corporate plans described in section 401. Because section 165 did not provide for a Keogh-type plan, the question arose whether to read section 3(c)(13) to apply to Keogh plans authorized under amended section 401.

Then-SEC Chairman William L. Cary testified that while "we have construed the employees' pension trust exemption of section 3(c)(13) of [the Investment Company Act] to be available" to bank collective investment funds for Keogh plans, "[t]his construction was not free from doubt, for it was not certain that Congress intended to exempt anything of this nature as an employees' pension trust." *Fascell Hearings, supra* note 22, at 7 (statement of William L. Cary). The Commission could have distinguished between H.R. 10 commingled funds and collective trust funds for other section 401 plans on the basis that employer-participants in H.R. 10 commingled funds were not able to fend for themselves. See Mundheim & Henderson, *supra* note 10, at 834-36.

[26]*See* Wade, *supra* note 19, at 396; see also G.T. Lumpkin, Jr., Vice President, Wachovia Bank & Trust Co., Address Before the 44th Mid-Winter Trust Conference of the Am. Bankers Ass'n (Feb. 5, 1963), *reprinted in Fascell Hearings, supra* note 22, at 114-20 (H.R. 10 impact on trust business); Mundheim & Henderson, *supra* note 10, at 822-23.

[27]The power to regulate bank trust activities was transferred from the Federal Reserve Board to the Comptroller of the Currency in 1962. Act of September 28, 1962, Pub. L. No. 87-722, 76 Stat. 668 (codified as amended at 12 U.S.C. § 92a). See also Wade, *supra* note 19, at 366.

[28]*Fascell Hearings, supra* note 22, at 38 (statement of James J. Saxon, Comptroller of the Currency).

restrictions in regulation 9[29] would address the Commission's concern that interests in the collective trust funds would be "publicly offered" for Securities Act purposes?'

Chairman Cary, in testimony concerning commingled managed agency accounts, concluded that an "investor in bank sponsored mutual funds is entitled to the same protection as the investor in non-bank sponsored mutual funds."[31] More specifically, in reply to the Comptroller's argument that bank regulation made unnecessary the investor protections of the federal securities laws, Chairman Cary stated that banking regulation was concerned primarily with controlling the flow of credit, maintaining an effective banking structure, and protecting de ositors.[32] Banking regulation does not address investors' need for information?' As will be discussed below,[34] Congress finally resolved in favor of the Commission the issue of whether bank collective trust funds for Keogh plans should be registered under the Investment Company Act, and whether interests in those funds should be registered under the Securities Act, when it enacted the 1970 amendments to the Investment Company Act.

B. Historical Treatment of Insurance Company Separate Accounts

In the late 1950's and early 1960's, large employers increasingly were willing to risk investing in equity securities to obtain a higher return and lessen the amount of cash required to fund their pension obligations.[35] The return on

[29]The Comptroller adopted regulation 9 in 1963. Fiduciary Powers of National Banks and Collective Investment Funds, 28 FR 3309 (1963) (codified as amended at 12 C.F.R. § 9). As adopted, paragraph (b)(5)(iv) of regulation 9.18 restricted national banks from advertising and publicizing their collective investment funds that consisted solely of retirement, pension, profit-sharing stock bonus, or other trusts exempt from federal income tax. This restriction was eliminated in 1972. Fiduciary Powers of National Banks and Collective Investment Funds, 37 FR 24161 (1972).

[30]*Fascell Hearings, supra* note 22, at 48-50 (statement of James J. Saxon, Comptroller of the Currency).

[31]*Id.* at 8-9 (statement of William L. Cary).

[32]*SEC Legislation,* 1963: *Hearings on S.1642 Before a Subcommittee of the Senate Committee on Banking and Currency,* 88th Cong., 1st Sess. at 54-55 (1963) (statement of William L. Cary, Chairman, SEC).

[33]*See id.* at 55.

[34]*See infra* note 48 and accompanying text.

[35]Stephen B. Middlebrook & George N. Gingold, *Mass Merchandising of Equity Products by Insurance Companies,* 3 CONN. L. REV. 44/47 (1970).

these investments, often managed by banks, was higher than that available from traditional insurance products.[36] To compete with the banks, insurance companies obtained state legislation allowing them to segregate premiums paid by employers from the insurance company's general reserves and invest the segregated funds in a broader and less conservative mix of securities than that normally permitted for insurance companies, with the entire investment risk of the segregated account placed on the insurance customer.[37]

The development of insurance company separate accounts raised the concern that insurance companies were engaging in the offer and sale of securities to the public and operating as investment companies. Ultimately, the courts held that separate accounts are subject to the requirements of the securities laws.[38]

To address the insurance industry's concern that it be allowed to compete with banks and other financial institutions providing investment management services on an equal footing, the Commission, in the early 1960's, adopted rules to provide exemptions for variable annuities and insurance company separate accounts that were similar to those afforded to bank products under section 3(c)(13). Rule 3c-3 under the Investment Company Act exempted from Investment Company Act regulation certain group annuity contracts held by an insurance company in a separate account?' The exemption was available only if the pension plan in connection with the group contract met the qualifications of sections 401 or 404(a)(2) of the Code. In addition, the Commission required that the group contract provide that regardless of the earnings of the separate

[36] *Id.*

[37] *Id.* at 47-48.

[38] *See* Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3rd Cir. 1964), *cert. denied*, 377 U.S. 953 (1964) (insurance company separate account could be required to register under the Investment Company Act).

[39] Exemption of Certain Transactions of Insurance Companies, Investment Company Act Release No. 3605 (Jan. 7, 1963), 28 FR 401 (adopting rule 3c-3). In adopting rule 3c-3, the Commission noted its intention to provide relief similar to that already available to pooled investment vehicles for employee benefits maintained by banks:

> Although the insurance companies may not be acting as trustees, the arrangements for utilization by employers of such special accounts maintained by insurance companies would be similar to arrangements excepted from the definition of investment company pursuant to Section 3(c)(13) of the Act, and maintained by bank trustees for the investment of funds which the employers have set aside to meet their obligations under qualified pension plans.

Id.

account, the retirement benefits to employees be payable in fixed dollar amounts;[40] cover at least 25 employees at the time it was executed; and prohibit employee contributions to the separate account. The Commission's position seems to have been predicated on the theory that Investment Company Act protection was not necessary where a plan was large and where the risk to pay defined benefits fell on the employer.

The Commission also adopted rule 156 under the Securities Act to bring transactions exempted from Investment Company Act regulation by rule 3c-3 conditionally within the nonpublic offering exemption in the Securities Act.[41] Rule 156 exempted these transactions from the registration requirements, but not from the antifraud provisions, of the Securities Act. The Commission conditioned the exemption, among other things, on there being no advertising in connection with the transaction. In adopting rule 156 the Commission noted that "[i]t has been represented to the Commission that because of the variety and complexity of such contracts, they must be separately negotiated with employers who retain expert advisers, are fully informed in the matter and are in a position to fend for themselves."[42]

In the late 1960's, the Commission adopted rule 6e-1. While rule 3c-3 exempted a narrow class of separate accounts entirely from Investment Company Act regulation, rule 6e-1 exempted a broader class of tax-qualified insurance company separate accounts from some parts of the Investment Company Act.[43] A separate account exempt under rule 6e-1 was allowed to contain employee contributions. In addition, the rule required that, if the retirement plan provided for benefits which varied to reflect the investment results of the separate account, the insurance company (1) make available to participating employers sufficient copies of a written disclosure statement for all covered employees, (2) recommend to the employer that it distribute the disclosure statement to each covered employee, and (3) file the statement with the Commission. The Commission required that the disclosure statement explain that the benefits to be received by employees would vary to reflect the investment experience of the separate

[40]The Commission later amended rule 3c-3 to allow group contracts to provide that retirement benefits payable to employees may vary depending on the extent of the employer's contributions. Exemption From Certain Contracts, Investment Company Act Release No. 4007 (July 2, 1964)' 29 FR 9433.

[41]*See* Certain Group Annuity Contracts; Exemptions, Securities Act Release No. 4627 (Aug. 1, 1963), 28 FR 8208 (adopting rule 156 under the Securities Act).

[42]*Id.*

[43]*See* Certain Separate Accounts of Insurance Companies, Investment Company Act Release No. 5741 (July 15, 1969), 34 FR 13019 (adopting rule 6e-1 under the Investment Company Act and conforming amendments to rule 156 under the Securities Act).

account, and that the assets held in the account would include common stocks and other equity investments.

C. Current Securities Laws Exemptions for Pooled Investment Vehicles

Congress's amendments to the Investment Company Act in 1970 included the current exemptions from the securities laws for bank collective trust funds and insurance company separate accounts holding retirement plan assets.[44] The amendments to section 3(c)(13) (which was renumbered section 3(c)(11)) essentially codified existing Commission positions with respect to collective trust funds[45] and provided a "level playing field" between banks and insurance companies that managed employee benefit plans assets through pooled investment vehicles.[46] . At the same time, Congress amended section 3(a)(2) of the Securities Act to exempt certain interests in collective trust funds and insurance company separate accounts for tax-qualified plans from registration under the Securities Act.[47] Interests issued by these pooled investment vehicles remain subject to the antifraud provisions of the Securities Act. The amendments to section 3(a)(2) also codified the Commission's position requiring registration of interests in Keogh plans, pooled investment vehicles for Keogh plans,[48] and plans under which employee contributions are permitted to be invested in securities issued by the employer.

[44]1970 Amendments, supra note 9 (codified as amended at 15 U.S.C. § 80a-3(c)(11)).

[45]*See* supra Section II.A. Many banks had relied on no-action relief under section 3(c)(13) of the Investment Company Act and the intrastate exemption in section 3(a)(11) of the Securities Act. Lybecker, supra note 12, at 235, n.107; Mundheim & Henderson, supra note 10, at 830, n.114.

[46]HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 1382, 91st Cong., 2d Sess. 10, 18 (1970) [hereinafter REPORT NO. 13821. In connection with these amendments, the Commission rescinded rules 3c-3 and 6e-1 under the Investment Company Act and rule 156 under the Securities Act. See Registration and Regulation of Insurance Company Separate Accounts, Investment Company Act Release No. 6430 (April 2, 1971), 36 FR 7897.

[47]1970 Amendments, supra note 9 (codified as amended at 15 U.S.C. § 77c(a)(2)).

[48]Although Keogh plans are qualified under section 401 of the Internal Revenue Code, Congress did not exempt interests in collective trust funds for Keogh plans from Securities Act registration, in part because of the likelihood that these securities would be sold to unsophisticated employers. REPORT NO. 1382, supra note 46, at 44. Instead, Congress gave the Commission rulemaking authority in section 3(a)(2) to exempt interests in these pooled investment vehicles under certain circumstances. See *infra* note 68 and accompanying text (Commission adopted rule 180 exempting from registration certain Keogh plans and their pooled investment vehicles).

Congress intended these amendments to respond to concerns expressed by both the banking and insurance industries that the lack of a clear exemption under the Securities Act for interests in pooled investment vehicles might expose banks and insurance companies to civil liability under the Securities Act.[49] Congress exempted these vehicles, in part, because they were subject to regulation under other provisions of law.[50] Congress assumed, however, that the person making the investment decisions for a plan, whether it was the sponsoring employer or a professional investment manager, was a sophisticated investor able to fend for itself and the plan participants with the application of only the Securities Act's antifraud provisions.[51]

The Commission generally supported the 1970 legislation extending the existing exemptions for qualified employee benefit plans to bank collective trust funds consisting solely of the assets of those plans.[52] In this connection, the Commission sought and retained the authority under section 3(a)(2) of the Securities Act to require registration of interests in single and collective trust funds for Keogh plans and interests in plans that invest employee contributions in employer securities. At the same time, the Commission opposed the legislation giving similar exemptions for insurance company separate accounts and interests therein. The Commission recognized that amending the Securities Act and Investment Company Act to exempt only the collective trust funds might give the banks an advantage over the insurance companies in competing to manage pension assets, but justified its position on the grounds that banks were already subject to more extensive regulation, by federal and state banking regulators, than were the insurance companies.[53] The Commission would have preferred to

[49] *See* **Employee Benefit Plans; Interpretation of Statutes, Securities Act Release** No. **6188 (Feb. 1, 1980), 45 FR 8960 (interpretive release on the treatment of employee benefit plans under the securities laws); Mundheim & Henderson,** *supra* **note 10, at 822.**

[50] *See* REPORT *NO.* **1382,** *supra* **note 46, at 10.**

[51] *See id.* **at 43-44.**

[52] *See Mutual Funds Legislation of* **1967:** *Hearing on Amendment No.* **438** *to* **S. 1659** *Before the Senate Committee on Banking and Currency,* **90th Cong., 1st** Sess. **1326-27 (1967) [hereinafter 1967** *Senate Hearings]* **(statement of Manuel F. Cohen, Chairman, SEC);** *cf. Investment Company Act Amendments of* **1967 --** *Bank and Insurance Company Collective Investment Funds and Accounts: Hearings on H.R.* **14742** *Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce,* **90th Cong., 2d Sess. 115, 117-18, 133 (1968) [hereinafter 1968** *House Hearings]* **(statement of Manuel F. Cohen, Chairman, SEC) (supporting extension of Investment Company Act exception to collective trust funds but opposing blanket exemption from Securities Act).**

[53] *See* **Letter from Hamer H. Budge, Chairman, SEC to Senator** John J. **Sparkman (Apr. 29,1969)** *reprinted in Investment Company Amendments Act of* **1969:** *Hearings on* **S. 34** *and S.* **296** *Before the Senate Committee on Banking and Currency,* **91st Cong., 1st Sess. 31-33 (1969) [hereinafter Budge (continued..)**

retain jurisdiction over insurance company separate accounts for employee benefit plan assets and to use its rulemaking authority to exempt separate accounts from some provisions of the Investment Company Act.[54]

Four years after the 1970 amendments, Congress enacted ERISA to provide comprehensive minimum standards for the administration of private employee benefit plans.[55] While ERISA was a response to the growth in size, scope, and number of corporate employee benefit plans, and their increasing importance to employees and to the economy as a whole, ERISA also authorized the establishment of Individual Retirement Accounts ("IRAs").[56] The new provisions permitted individuals not covered by an employer or government plan to establish, and make deductible contributions to, their own IRA. IRAs do not meet the requirements for qualification under section 401 of the Code and accordingly, virtually from the time of their creation, the staff has taken the position that the exception in section 3(c)(11) is not available to bank collective funds that pool IRA assets or commingle the assets of IRAs with corporate plans qualified under section 401 of the Code.[57] The staff did not believe that the historical justifications for the exemptions for pooled investment vehicles for employee benefit plans could support exempting pooled vehicles for IRAs, since the participants generally would be less able to fend for themselves than even the self-employed participants in Keogh plans.

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[53](...continued)
Letter]; *1968 House Hearings, supra* note 52, 137 (statement of Manuel F. Cohen); *1967 Senate Hearings, supra* note 52, at 1334-35 (statement of Manuel F. Cohen).

[54]Budge Letter, *supra* note 53; *1967 Senate Hearings, supra* note 52, at 133435 (statement of Manuel F. Cohen).

[55]Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. § 1001).

[56]*Id.* at § 2002(b), 88 Stat. at 959 (1974) (codified as amended at 26 U.S.C. § 408).

[57]*See, e.g.,* Santa Barbara Bank and Trust (pub. avail. Nov. 1, 1991); United Missouri Bank of Kansas City, N.A. (pub. avail. Dec. 31, 1981); Continental Illinois National Bank & Trust Co. of Chicago (pub. avail. April 28,1975).

The staff believes that pooled funds for IRAs require the protection of both the Securities and Investment Company Acts in part because interests in them would be offered to the general public as investments, not simply because IRAs are authorized under section 408 instead of section 401. *Cf.* Continental Illinois National Bank & Trust Co. of Chicago, *supra.*

The fact that a collective trust fund for IRAs is not excepted from the provisions of the securities laws has been explicitly recognized by Congress. See SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, STUDY OUTLINE: THE SECURITIES ACTIVITIES OF COMMERCIAL BANKS, 94th Cong., 1st Sess. 13 (1975).

Congress created the 401(k) plan, now the most popular type of defined contribution plan, by amending section 401 of the Code in 1978.[58] This amendment exempted from taxation certain profit-sharing and stock bonus plans that allowed employees to elect to receive, as part of their taxable income, the employer's contribution or, instead, defer receipt of, and taxation on, the contribution. If the employee elected to defer receipt of the contribution, it would be invested in a trust where the contributions and the earnings thereon would accumulate tax-free until disbursed.

The Supreme Court, in 1979, held that participant interests in involuntary, noncontributor ension plans are not securities under the Securities Act and the Exchange Act? 'Subsequently, the Commission issued two major interpretive releases clarifying the treatment under the Securities Act of employee benefit plans not covered by the Supreme Court's decision?' These releases repeated the longstanding position that an employee's interest in a corporate pension or profit-sharing plan falls within the Securities Act's definition of "security" if the plan is both voluntary and contributory, but that registration is required only if the plan permits employee contributions to be invested in employer securities!' The Commission did not require interests in other plans to be registered for two reasons: (1) participants generally do not make investment decisions for an involuntary plan, and (2) the Commission did not wish to impose on an employer the cost of registering the interests in a plan except where the employer had a direct financial interest in soliciting voluntary employee contributions, such as where employee contributions are used to purchase the employer's securities.[62] At this time, 401(k) plans were funded entirely by employer contributions. Accordingly, the staff took the position that 401(k) plans were noncontributory and that, therefore, interests in 401(k) plans were not subject to the Securities Act.[63]

[58]Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763, 2785-87 (1978) (codified as amended at 26 U.S.C. § 401(k)).

[59]International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

[60]Employee Benefit Plans, Securities Act Release No. 6281 (Jan. 15, 1981), 46 FR 8446 (supplemental release on application of Securities Act to employee benefit plans); Sec. Act Rel. 6188, *supra* note 49 (stating staff's position on application of Securities Act to employee benefit plans).

[61]Sec. Act Rel. 6188, *supra* note 49.

[62]*Id.* See Lybecker, *supra* note 12, at 230. Interests in plans that are required to be registered generally are registered on Form S-8, a simplified registration form that now allows a registrant to incorporate certain ERISA disclosure documents by reference. The form is available to reporting companies. See Sec. Act Rel. 6867, *supra* note 14.

[63]Sec. Act Rel. 6281, *supra* note 60.

Congress revisited the securities law exclusions for bank and insurance company pooled investment vehicles in 1980 in relation to governmental plans. It amended the securities laws to exclude interests in single and pooled governmental plans from registration under both the Securities Act and the Exchange Act, and governmental plans and their pooled investment vehicles from regulation under the Investment Company Act.[64]

In 1981, the Internal Revenue Service issued rules under section 401(k) of the Code, allowing plans to provide for pre-tax "out-of-pocket" employee contributions through salary reduction.[65] The Commission staff subsequently stated that interests in 401(k) plans that permit employees to contribute voluntarily a portion of their compensation would be securities.[66] Although a salary reduction 401(k) plan would involve the issuance of a security, registration of the interests in a 401(k) plan generally would not be required unless employee contributions are permitted to be invested in employer stock.[67]

The last major action affecting the employee benefit exceptions occurred in 1981 when the Commission adopted rule 180.[68] The rule conditionally exempts an interest in a Keogh plan, and the plan's interest in a pooled investment vehicle, from Securities Act registration on the basis of the financial sophistication of the sponsoring employer or on the employer's use of an independent professional manager.

[64]Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, §§ 701-03, 94 Stat. 2275, 2294-96 (1980) (codified at 15 U.S.C. §§ 77c(a)(2)(C) (Securities Act § 3(a)(2)(C)), 78c(a)(12)(C) (Exchange Act § 3(a)(12)(C)), 80a-3(c)(11) (Investment Company Act § 3(c)(11))).

[65]*See* Certain Cash or Deferred Arrangements Under Employee Plans, 46 FR 55544 (1981) (notice of proposed rulemaking); Income Tax; Taxable Years Beginning After December 31,1953 and OMB Control Numbers Under the Paperwork Reduction Act; Certain Cash or Deferred Arrangements Under Employee Benefit Plans, 53 FR 29658 (1988) (final regulations, codified as amended at 26 C.F.R. § 1.401k-1. *See* generally Curtis Vosti, *Creator* Faced *Long* Struggle, PENSIONS & INVESTMENTS, Od. 28,1991, at 17 (establishment of 401(k) plans that allow employees to make pre-tax contributions).

[66]*See* 1 Pens. Plan Guide (CCH) ¶ 1112 (Dec. 7, 1990); Diasonics, Inc. (pub. avail. Nov. 29, 1982).

[67]Diasonics, Inc., supra note 66.

[68]Exemption From Registration of Interests and Participations Issued in Connection With Certain H.R. 10 Plans, Securities Act Release No. 6363 (Nov. 24, 1981), 46 FR 58287 (codified at 17 C.F.R § 230.180).

111. Recent Developments in the Employee Benefit Plan Industry

The 1980's witnessed a marked shift toward the establishment of defined contribution plans among employers, although defined benefit plans still contain the majority of retirement plan assets.[69] As noted above?' under a defined benefit plan, the employer is obliged to pay retirement benefits of specified amounts to employees meeting the plan's eligibility and vesting requirements. Defined contribution plans only obligate an employer to make contributions to the participant's account in the plan. The retirement benefits the employee receives will depend on the amount of assets in his or her account at retirement.[71] In a defined benefit plan, the employer bears the investment risk of ensuring that there are sufficient assets to meet the plan's obligations;[72] in a defined contribution plan, the investment risk falls upon the plan participants.

A. Increase in Number of Defined Contribution Plans

Defined benefit plans continue to be the primary type of private pension plan, covering more workers and containing more assets than defined contribution plans. During the past decade, however, the number of defined contribution plans has grown dramatically and the number of defined benefit plans has decreased correspondingly, especially among mid-sized employers.[73] Defined contribution plans constitute 81% of all pension plans (see Figure 3-1).[74]

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[69] *See* PENSION BENEFIT GUARANTY CORPORATION, PENSION PLAN CHOICE, 1979-1987: CLARIFICATIONS AND EXTENSIONS (1990) [hereinafter PBGC STUDY]; CLARK & MCDERMED, *supra* note 15.

[70] *See supra* pp. 1-2.

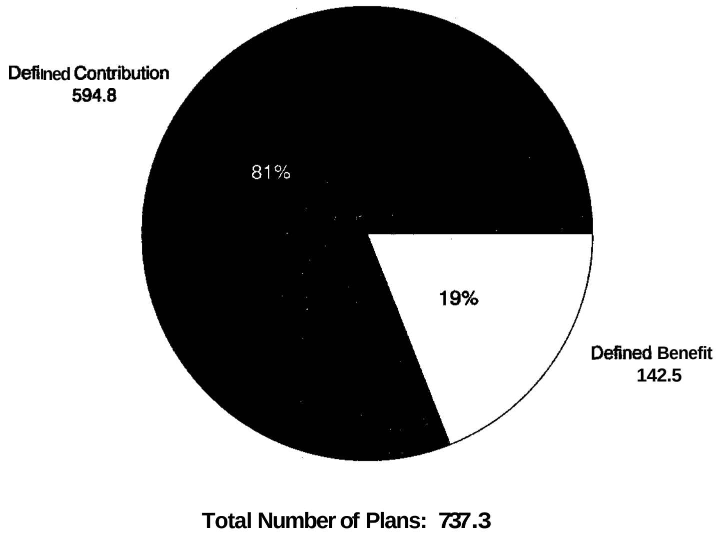
"*See* 29 U.S.C. § 1002(34) (definition of defined contribution plan).

[72] *See* 29 U.S.C. § 1002(35) (definition of defined benefit plan).

[73] Approximately 51 million workers, 55% of the full-time labor force, will be covered by a private retirement plan (either defined benefit or defined contribution) at the end of 1991. The coverage rate for employees in smaller firms is lower. Less than 25% of small employers provide retirement benefits. Frank Swoboda, *White House Proposes New Pension Laws,* WASH. POST, May 1, 1991, at F1.

[74] EBRI, *supra* note 4, at 8, Table 3. Defined contribution plans constitute 83% of pension plans covering fewer than 100 participants. *See* id.

FIGURE 3-1
Total Number of Pension Plans in 1988
(thousands)



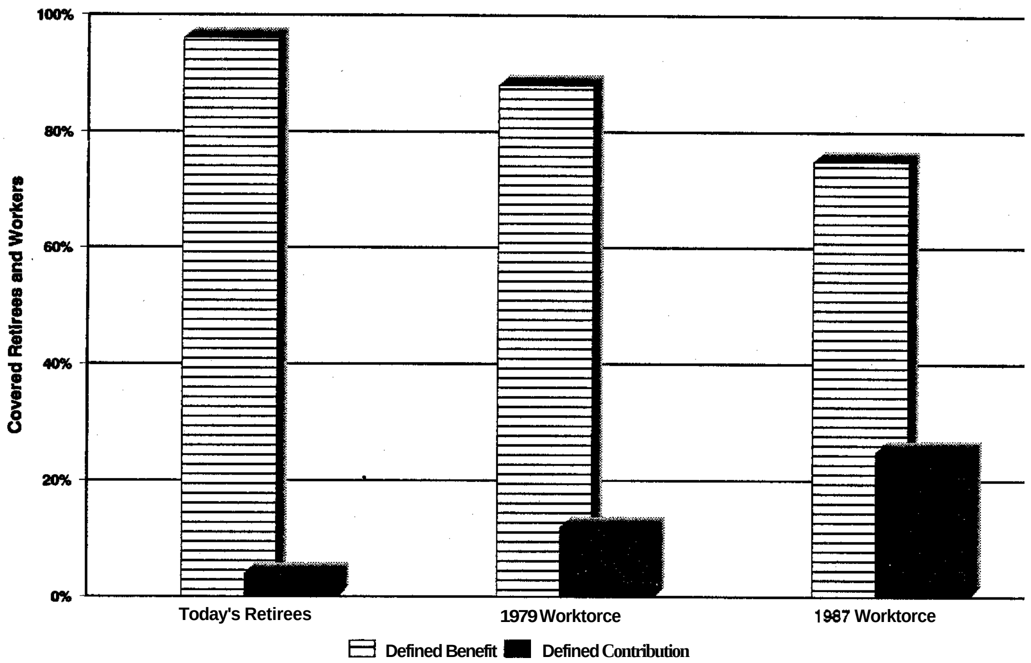
Source: Employee Benefits Research Institute

Among retired workers currently receiving pensions, 96% were participants in defined benefit plans, while only 4% were participants in defined contribution plans.[75] Moreover, while 88% of all workers covered by a retirement plan in 1979 were covered by a defined benefit plan, by 1987 only 75% of those covered were under a defined benefit plan (see Figure 3-2).[76]

[75] U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS MILLIONS OF WORKERS LOSE FEDERAL BENEFIT PROTECTION AT RETIREMENT 4-5 (1991).

[76] PBGC STUDY, supra note 69, at 2. By contrast, the study notes that the portion of workers covered primarily by a defined benefit plan was relatively stable during the period from 1960 to 1980. Id. See generally CLARK & MCDERMED, supra note 15, at 81-90 (data from 1977-85 show increasing use of defined contribution plans as primary pension plan among employers of all sizes, especially smaller employers).

FIGURE 3-2
Growing Role of Defined Contribution Plans



Source: U.S. General Accounting Office
PersianBenefit Guaranty Corp

Analysts attribute the change to a variety of factors, including: changes in employment patterns, which have resulted in greater numbers of workers employed by smaller firms;[77] the authorization of the 401(k) plan in 1978; the increased administrative costs associated with operating a defined benefit plan, particularly for smaller plans;[78] and the importance to employers of being able

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[77]*See* James B. Lockhart, ***PBGC** Advocates Defined-Benefit Plan Growth,* PENSION WORLD, Feb. **1990,** at 38/40 (noting that "more people are working for smaller and/or service sector employers, who are inclined to establish defined-contribution plans"). However, changing employment patterns appear to account for only 20% of the shift in plan choice. *See* PBGC STUDY, *supra* note **69,** at **1, 5.** The PBGC STUDY also notes that 70% of the switch to 401(k) plans is "attributable to firms that otherwise would have been more likely to have chosen defined-benefit plans." *Id.* at **19.** *See also* CLARK & MCDERMED, *supra* note **15,** at **91.**

[78]*See* PBGC STUDY, *supra* note **69,** at **1.** *See also* Peter F. Drucker, *Reckoning with the Pension Fund Revolution,* HARV. Bus. REV., Mar.-Apr. **1991,** at **106,112** (poor investment performance and new accounting standards for underfunding mean that employers will move away from defined benefit plans). *But see* Barry B. Burr, *Reckoning with **Notions** of Drucker,* PENSIONS & INVESTMENTS, May 13, **1991,** at **12** (disputing Drucker's assertions about investment performance of defined benefit plans). An employer must report unfunded defined benefit plan obligations as a liability
(continued...)

to predict and control liabilities more accurately with defined contribution plans.[79]

B. Growth of 401(k) Plans

The popularity of one particular type of defined contribution plan -- the 401(k) plan – is a major cause of the growth of defined contribution plans relative to defined benefit plans.[80] Many employers, large and small, are establishing these plans.[81] There are many reasons why 401(k) plans are the fastest growing form of defined contribution plan. Employers like 401(k) plans because the employees contribute through salary reduction, which lowers the employers' cost of providing retirement benefits. In addition, employers believe that a 401(k) plan helps to attract and retain employees.[82] Like other defined contribution plans, the employer's 401(k) cost of complying with ERISA is lower, the employees bear the investment risk, and the employer can more easily predict its future liability.[83] Employees like 401(k) plans because they can make voluntary ***pre-tax*** contributions to a plan, taxes are deferred on employees' earnings under a plan, and their employers usually match a percentage of their contributions, thereby instantly increasing the employees' retirement savings. Employees further like that they are able to exert some control over how their 401(k) plan contributions are invested.[84] These plans are also attractive to employees because the assets

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[78](...continued)
on its balance sheet. *See* EMPLOYERS' ACCOUNTING FOR PENSIONS, Statement of Financial Accounting Standards No. **87, § 36** (Fin. Accounting Standards Bd. **1985).**

[79]INVESTMENT COMPANY INSTITUTE, PERSPECTIVE ON MUTUAL FUND ACTIVITY: HOLDING THE COURSE (Fall **1991)** at 17-18. *See* also Daniel H. Jackson & William J. McDonnell, ***What's** Behind the Switch to Defined Contribution Plans?*, PENSION WORLD, Aug. **1990,** at **40, 41** [hereinafter Jackson **&** McDonnell]**.**

[80]*See* PBGC STUDY, ***supra*** note **69,** at **13-22;** Feinberg, *supra* note **4,** at **34;** Curtis Vosti, ***401(k)*** *'Clarification' a Crossroads,* PENSIONS **&** INVESTMENTS, Oct. **28, 1991,** at **17** [hereinafter ***401(k)*** *Clarification*].

[81]*See* Feinberg, *supra* note **4,** at **36;** Henry von Wodtke and Nancy Sabatiel, ***401(k)*** *Keeps **Status** as America's Favorite Employee **Benefit**,* PENSION WORLD, Nov. **1991,** at **14** [hereinafter Wodtke & Sabatiell; ***401(k)*** *Clarification, supra* note *80.*

[82]***See*** PBGC STUDY, supra note **69,** at **14/16;** Wodtke **&** Sabatiel, supra note 81, at **14;** Peter Starr, *Competitive **401(k)** Plans,* PENSION WORLD, Apr. **1991,** at **48.**

[83]***See** generally* Richard N. Pallan, *Defined Responsibility **Should** Follow Popularity* of *Retirement Plans,* PENSION WORLD, Dec. **1991,** at **34;** Feinberg, supra note 4, at **34, 36.**

[84]***See*** Wodtke **&** Sabatiel, *supra* note **81,** at **15; *401(k)*** *Clarification, supra* note **80,** at 17; Starr, *supra* note **82.**

in the plan are "portable," the participant can more easily ascertain his or her account balance, and many plans allow a participant to borrow from the account.[85]

According to estimates, 401(k) plans now have nearly $300 billion in assets and continue to grow rapidly.[86] **A** recent survey found that 82% of participants in 401(k) plans decide how their own contributions are to be invested and **54%** of participants decide how their employers' contributions are to be invested.[87]

C. Growth in Defined Contribution Plan Assets

Available statistics show that defined contribution plans represent a growing portion of the nation's retirement plan assets. The proportion of assets invested in defined contribution plans has grown steadily since the mid-1970s. Defined contribution plan assets grew from 28% of total private pension assets in 1975 to 39% in 1988 (see Figure 3-3).[88]

[85]*See* Feinberg, *supra* note **4,** at **34/38;** Jackson & McDonnell, *supra* note **79,** at **41;** Starr, *supra* note **82.** *See also* Sheldon R. Barker, *In Pursuit of 401(k) Dollars: A Billion Here; A Billion There; Pretty Soon You are Talking Real Money*, FUNDS **AGENTS** CUSTODIANS SUPPLIERS, Summer **1991,** at **7-8.**

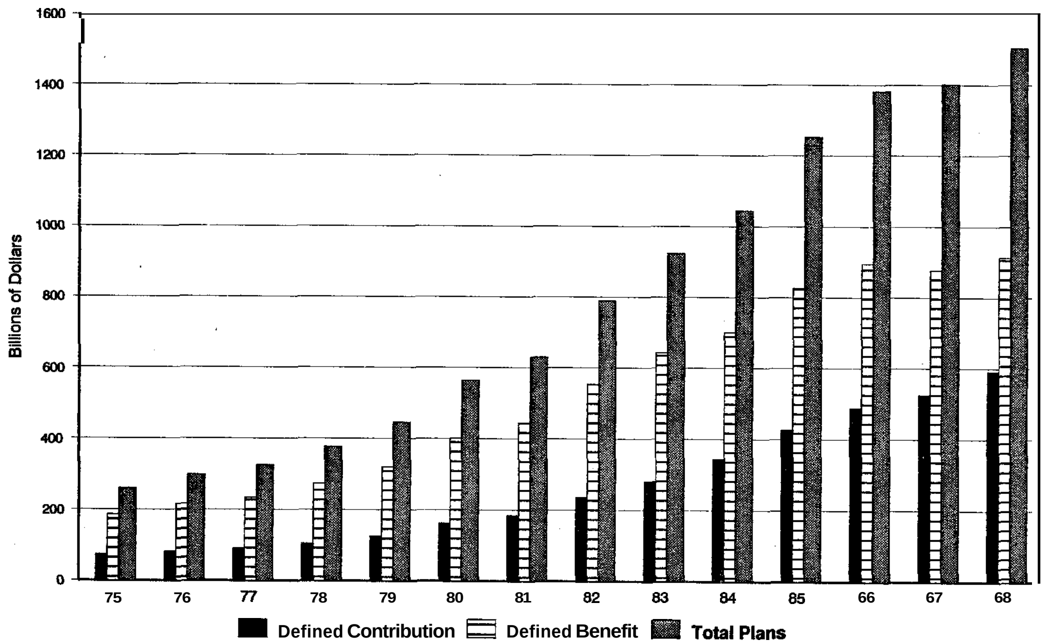
Defined contribution plans increasingly are used by participants as a means of general purpose investment. Most employees who obtain lump sum payments of their **401(k)** plan accounts when they change jobs spend the money rather than place it in another retirement account. *See* Department of Labor Press Release No. **91-200** (Apr. **30,1991);** Swoboda, *supra* note **73,** at **F2.** Many participants view their 401(k) plan as a means of saving for needs other than retirement, even though the 401(k) plan may be the only employer-sponsored source of retirement income for increasing numbers of employees. *See* Jackson & McDonnell, *supra* note **79,** at **41.** In this respect, defined contribution plan investment vehicles compete with investments that are available to investors outside of their retirement plans.

[86]*See* Barker, *supra* note 85, at **7;** Bill Montague, *401(k)s Offer Options Gain Appeal*, **USA** TODAY, May 20, **1991,** at **3B;** Joel Chernoff, *New Rule Increases Flexibility*, PENSIONS & INVESTMENTS, Dec. **24,1990,** at **30.**

' PROFIT SHARING COUNCIL OF AMERICA, 34TH ANNUAL SURVEY OF PROFIT SHARING AND 401(K) PLANS **15 (1991).** The survey also found that **74%** of plan participants who make after-tax contributions direct the investment **of** their contributions. *Id.*

[88]PENSION AND WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, TRENDS IN PENSIONS **1991** (John A. Turner & Daniel J. Beller, eds., forthcoming **1992)** [hereinafter PWBA] (manuscript at Table **16.11,** on file with Division).

FIGURE 3-3
Pension Plan Assets By Type of Plan 1975-88



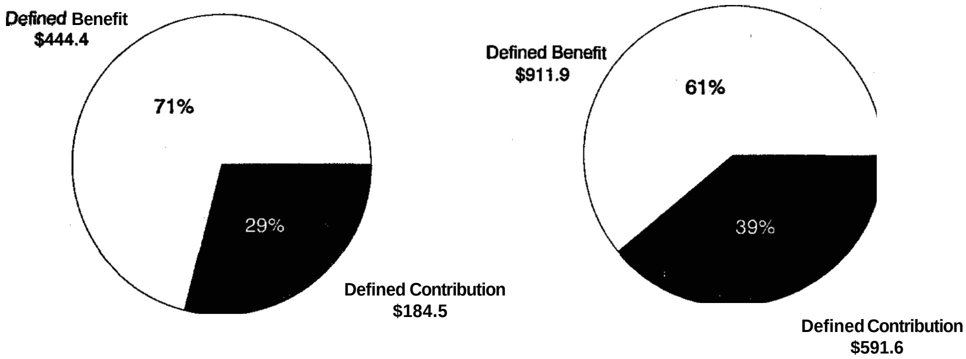
Source: Pension & Welfare Benefits Admin.

Most **of** this growth has occurred since 1981,[89] the first year the IRS allowed pre-tax contributions by employees through salary-reduction (see Figure 3-4).[90]

[89]*Id.*

[90]*See* supra note 65 and accompanying text.

FIGURE 3-4
Comparison of Pension Plan Assets 1981 vs. 1988



1981
Assets: $628.9 Billion

1988
Assets: $1,503.6 Billion

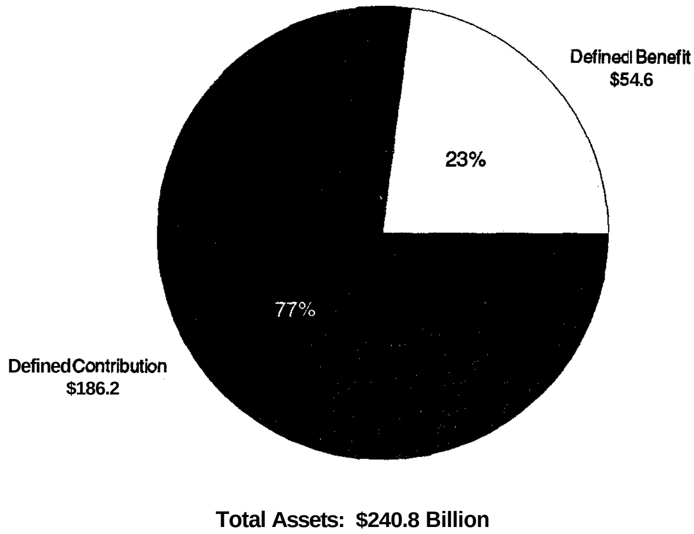
Source: Pension & Welfare Benefits Admin.

The vast majority of all private pension plans existing in 1988 covered a single employer with fewer than 100 participating employees?' Defined contribution plans are overwhelmingly the pension plan of choice for smaller employers as evidenced by 77% of their assets being invested in defined contribution plans (see Figure 3-5).[92]

[91]EBRI, *supra* note **4, at 7.**

[92]PWBA, *supra* ***note*** *88.*

FIGURE 3-5
1988 Pension Pian Assets
Small Plans



Source: Pension & Welfare Benefits Admin.

D. Competition Among Mutual Funds, Banks, and Insurance Companies

The trend toward greater participant direction of defined contribution plan accounts has intensified competition among mutual funds, banks, and insurance companies for the management of retirement plans, especially 401(k) plan assets (see Table 3-1).[93]

[93]Banks, insurance companies, and mutual funds compete for market share by emphasizing, where relevant, differences in investment performance and expertise in management, the security of assets underlying the investments offered, recordkeeping services, "one-stop shopping" for combined services, or participant services such as daily valuation and telephone switching. See Diane Levick, *Insurance Companies,* Banks, *Mutual Funds Vie,* HARTFORD COURANT, Oct. **8,1990;** *see also* Curtis Vosti, *Adapting to Change,* PENSIONS & INVESTMENTS, Sept. 30, **1991,** at **1** (banks and mutual funds offer innovative services and new investment strategies to attract **401(k)** plan investments). Some fund management groups have set up registered investment companies specifically for the assets of qualified plans.

Table 3-1
Total Pension Plan Assets (billions) in Pooled Vehicles, 1990

bank collective trust funds	$267
insurance company separate accounts	$135
mutual funds	$ 36

Sources: Employee Benefit Research Institute, American Council of Life Insurance, Investment Company Institute

As evidence of the increased competition for defined contribution plan assets, a recent survey of the 100 largest U.S. bank and trust corporations found that many banks and trusts offer services to 401(k) plan clients comparable to those provided by mutual funds, including daily valuation and a variety of investment products.[94] Eighty-five percent of the banks and trust companies responding to the survey offer collective investment funds and "slightly more than half" offer mutual funds. Of those that offer mutual funds, sixty-eight percent offer proprietary funds (*i.e.,* funds available only to the banks' customers). The consultant that conducted the survey expressed the view that "the trend toward proprietary mutual funds is due to client [*i.e.,* the plan sponsor or administrator] demand for daily valuation."[95] The survey also noted that banks and trust companies increasingly are offering computerized "on-line" services to their 401(k) plan clients.[96]

IV. Information Provided to Investors

As discussed above,[97] employees increasingly participate in defined contribution plans, and increasingly make their own investment decisions regarding the assets in these plans. These changes eviscerate the original rationale for the exemptions from securities disclosure requirements for pooled

[94]OPTIMA GROUP, INC., NATIONAL 401(K) MARKETING TRENDS 9 (1990).

[95]*Id.*

[96]*Id.* at 10.

[97]*See* supra Section III.

investment vehicles -- that large employers, making the investment decisions and bearing the investment risks, could obtain needed information without disclosure requirements.

Another possible rationale for these exemptions is that they are unnecessary in light of the other federal regulations now applicable to pension plans and their pooled investment vehicles. As this section shows, however, these regulations do *not* ensure that participants in defined contribution plans receive the information they would receive under the federal securities laws, or the information they need to make informed investment decisions.

A. Comparison of Disclosure and Reporting Requirements

Investment companies, bank collective trust funds, and insurance company separate accounts are each subject to distinct disclosure and reporting requirements. These schemes of regulation are described below.

1. Prospectuses; Written Plans

An investment company must register itself under the Investment Company Act and the securities it issues under the Securities Act. The disclosures required under the securities laws as a result of registration include a prospectus which contains information about the fund's fundamental investment objectives and policies; performance information covering ten years; information about the investment manager's background and compensation; how to purchase and redeem shares; and a table summarizing the fund's fees and expenses and their effect on a shareholder's investment. Section 5 of the Securities Act requires that a copy of the prospectus precede or accompany any security sold.

Under the Securities Act, an investment company sponsor offering shares in an investment company can be sued for damages if the registration statement is materially misleading or defective,[98] if the sponsor fails to deliver a prospectus in connection with the sale of a security,[99] or if the sponsor or its employees offer or sell any security by means of a prospectus or oral communication that includes a material misstatement or omission.[100] The investment company's underwriter and board of directors are also liable under section 11 of the Securities Act for a materially misleading or defective registration statement. In addition, a shareholder can bring an action for fraud

[98]Securities Act § 11, 15 U.S.C. § 77k.

[99]Securities Act § 12(1), 15 U.S.C. § 77l(1).

[100]Securities Act § 12(2), 15 U.S.C. § 77l(2).

under rule 10b-5 of the Exchange Act in connection with the purchase or sale of an investment company's securities.

ERISA disclosure requirements focus primarily on information about the plan itself, rather than on detailed information about the vehicles that fund the plan. Under ERISA, participants must receive a Summary Plan Description that must be updated periodically if material changes occur in the plan?[101] The Summary Plan Description summarizes the participants' rights and obligations under a plan, including the plan's eligibility and vesting provisions, procedures for presenting benefits claims, and the method by which contributions to the plan are determined. With respect to the plan's investments, the Summary Plan Description is required to include only the identity of any investment vehicles in which the plan invests.[102] Thus, ERISA does not require a plan's investment vehicles to provide disclosure to the plan fiduciaries or participants nearly comparable to that provided to investors by investment companies or other issuers under the federal securities laws. With respect to participant-directed plans, while employers currently make available information about investment vehicles to participants in a number of ways, the participant must take the initiative to obtain the information; **ERISA** does not require the plan fiduciaries or the employer to furnish participants with information about their investments.[103]

Recently proposed regulations of the Department of Labor, if adopted, would shift even greater responsibility for investment decisions from the plan fiduciaries to the employees and heighten participants' need for information.[104]

[101] 29 U.S.C. §§ 1022(a)(1), 1024(b).

[102] *See* 29 U.S.C. § 1022; 29 C.F.R. § **2520.102-3.** Indeed, some commentators advocate providing plan participants with the least information possible. One writer has suggested that, with respect to underperforming 401(k) plans, "it makes sense not to name the mutual fund, or investment advisor used for the investment choices. Use generic terms: equity fund, fixed fund, balanced fund. That way, changes can be made behind the scenes without upsetting the employees." Renee Brody Levow, *How to Get Your Employees to Love You and Their 401(k),* PENSION WORLD, Aug. **1990,** at **39.** This abbreviated disclosure apparently would not satisfy ERISA's requirement that the Summary Plan Description identify the plan's investment vehicles.

[103] Employers may make available information to employees by providing a prospectus, if one is available and if requested by a participant; through "on-line" computerized information services; through other written materials; by use **of** a bulletin board; or **by** referring participants to other sources of information. *See generally* Julie Rohrer, *The Communications Cloud Over 401(k)s,* INSTITUTIONAL INVESTOR, Sept. **1991,** at **189** (increasing need for information about investment options).

[104] The Department of Labor first proposed rule 404c-1 in **1987.** Proposed Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 52 FR (continued...)

Plan fiduciaries would be relieved of their fiduciary obligations for choosing plan investments where participants are provided with an opportunity to exercise control over the assets in their individual accounts and given an opportunity to choose from a broad range of investments, including at least three diversified categories of investments. While the proposed regulations would require that sufficient information be available from public sources for the three investment options, they would not require the plan fiduciary actually to *furnish* adequate written information about designated alternatives to those participants who request it.[105] Further, the sufficient information requirement would not apply to any investment options over and above the required three.

Under ERISA, a participant, fiduciary, or the Secretary of Labor may bring a civil action to enforce any provision of ERISA, including the right to receive a Summary Plan Description.[106] Participants and fiduciaries may also bring civil actions for violations of the terms of the plan. Further, the Secretary of Labor may levy fines against a plan administrator who fails to comply with a participant's request for information required under ERISA's reporting and disclosure requirements in a timely manner, where ERISA requires that such information be provided to the participant upon request.

The Comptroller's rules for bank collective funds require banks to make available upon request a written plan, approved by the bank's board of directors, that generally describes the policies of the bank with respect to the fund, the allocation of income, profits and losses, and the terms for admission and withdrawal.[107] The bank must make available upon request an audited annual financial report that includes a list of the fund's investments, income and disbursements, and fees charged by the bank to the fund. That financial report may, but need not, include a description of the fund's value on previous dates, as well as its income and disbursements during previous periods.[108] The

[104](...continued)
33508 (1987) (proposing 29 C.F.R. § 2550.404c-1). The 1987 proposal elicited a number of comments and a public hearing was held to address certain controversial aspects of the rule. After considering the comments and testimony, the Department of Labor substantially revised the 1987 proposal and reproposed rule 404c-1 in 1991. Participant Directed Individual Account Plans, 56 FR 10724 (reproposing 29 C.F.R. § 2550.404~-1).

[105]If the investment options are limited to investments designated by the plan, the plan must make available an identified plan fiduciary to direct employees to sources of information. *Id.* at 10728, 10737 (proposed 29 C.F.R. § 2550.404c-1(b)(3)(iii)).

[106]29 U.S.C. § 1132(a)(3), (5).

[107]12 C.F.R. § 9.18(b)(1).

[108]12 C.F.R. § 9.18(b)(5).

Comptroller of the Currency has general authority to fine any national bank or affiliated party for violations of any provision of the laws or regulations governing national banks, including failure to provide these materials, but investors have no private right of action?[109]

2. Shareholder and Periodic Reports

a. Shareholder Reports

An investment company must provide reports to shareholders of record at least semi-annually.[110] The semi-annual report must contain the fund's balance sheet; an income statement; a portfolio schedule that shows the amount and value of each security owned by the fund on that date; a statement of operations (net changes); and condensed financial information (the per share table)?[111] The annual report must include audited financial statements accompanied by a certificate of an independent public accountant.[112]

The Exchange Act also requires investment companies to provide reports to shareholders. Any proxy solicitation with respect to an annual meeting for the election of directors must be preceded or accompanied by an annual report to shareholders.[113] A bank or other fiduciary who holds securities in nominee name is generally required to pass through all proxy materials, including shareholder reports, to the beneficial owners on whose behalf it holds the securities.[114]

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[109]*See* 12 U.S.C. § 93(b). The statute provides a formula for determining the amount of any fine. Id.

[110]15 U.S.C. § 29(d); 17 C.F.R. § 270.30d-1.

[111]The per share table in an annual report must contain financial information for five years. The per share table in a semi-annual report must contain financial information for the period covered by the report and the preceding fiscal year. Item 23, Instruction 5(ii) to Form N-1A, Investment Company Act Release No. 13436 (Aug. 12, 1983), 48 FR 37928.

[112]15 U.S.C. § 80a-29(d), (e); 17 C.F.R. § 270.30d-1.

[113]17 C.F.R. § 240.14a-3(b).

[114]17 C.F.R. § 240.14b-2. Participants in an employee benefit plan are considered to be the beneficial owners entitled to receive proxy materials if they have the right under the plan or otherwise to vote the securities held on their behalf. See Shareholder Communications Facilitation, Securities Exchange Act Release No. 23847 (Nov. 25, 1986), 51 FR 44267. Employee benefit plans sponsored by the issuer or an affiliate of the issuer must comply with different procedures regarding the delivery of shareholder reports and proxy materials. See Facilitation of Shareholder Communications, Securities Exchange Act Release No. 25631 (Apr. 27, 1988), 53 FR 16399 (continued...)

ERISA requires that participants receive a Summary Annual Report that discloses the net change in the value of the plan's assets, net unrealized appreciation of plan assets, total expenses, and total income.[115] The Summary Annual Report is not required to include information about a plan's investments.[116] The Summary Annual Report is a condensed version of the detailed annual report that must be filed on Form 5500 with the IRS, which must include, among other things, audited financial statements and information about the plan's investments.[117] ERISA does not require the participant to be given the plan's Form 5500. Consequently, a participant will have to request a copy of Form 5500 from the plan administrator if it wants financial information about the plan's investments.[118] If a plan invests in a bank collective trust fund or an insurance company separate account, plan participants who request a copy of the plan's Form 5500 will also receive a copy of the annual statement of assets and liabilities of the collective trust fund or separate account.[119] ERISA regulations do not require independently-audited financial statements as to plan assets held in a collective trust fund or a separate account if the statements are prepared by a bank or insurance company regulated, supervised, and subject to examination by a state or federal agency and such statements are certified by the bank or insurance company and made part of the annual report.[120]

In addition to its filing obligations under ERISA, a national bank that administers a collective trust fund is required by the Comptroller's rules to

[114](...continued)
(adopting rules excluding some employee benefit plan participants from proxy processing and direct communications provisions).

[115]29 U.S.C. § 1024(b)(3); 29 C.F.R. § 2520.104b-10.

[116]Form for Summary Annual Report Relating to Pension Plans, 29 C.F.R. § 2520.104b-10(d)(3).

[117]A plan does not file its Form 5500 annual report directly with the Department of Labor. Plans sponsored by smaller employers may file a simplified annual report on Form 5500-C or Form 5500-R with the IRS, without audited financial statements.

[118]*See* 29 C.F.R. § 2520.104b-10(d)(3).

[119]ERISA requires banks and insurance companies to provide sufficient information to plan sponsors to allow them to complete Form 5500, including a copy of the statement of assets and liabilities of any collective trust fund or separate account in which the plan invests. 29 U.S.C. § 1023(a)(1)(B)(2). ERISA also requires plans to file with its Form 5500 an annual statement of assets and liabilities for any collective trust fund or separate account in which it invests. 29 U.S.C. § 1023(b)(3)(G). Alternatively, the bank or insurance company may file the statement directly with the Department of Labor and provide a copy to the plan administrator, in which case the plan's Form 5500 incorporates the statement by reference. 29 U.S.C. § 1023(b)(4); 29 C.F.R. § 2520.103-9.

[120]29 U.S.C. § 1023(a)(3)(C); 29 C.F.R. § 2520.103-8.

prepare an audited financial report of the fund at least once a year.[121] The financial report must include a list of the fund's investments, income and disbursements, and fees charged by the bank to the fund. Unlike an investment company's obligation to *deliver* financial information to shareholders and similar to ERISA's requirement that financial information about the plan *be made available upon request to plan participants*, banking regulations only require a national bank to *provide notice of the availability* of the annual financial report to any ***plan*** invested in its collective trust fund.[122] While a bank must furnish a plan with a copy of the financial report upon request, there is no specific requirement under the banking regulations that the bank furnish annual financial reports to *plan participants.*

b. Periodic Reports

Investment companies must annually and semi-annually report to the Commission on Form N-SAR.[123] The annual report must include financial information and an annual report by the independent accountant on the material weaknesses in internal accounting controls noted during its audit.[124]

Employee benefit plans are required to file an annual report with the IRS on Form 5500, including audited financial statements, as described above.[125]

Bank collective trust funds are not required to file periodic reports with the Comptroller.[126] The auditor of a collective fund's annual financial report, described above, is not required to file any report pointing out weaknesses in a fund's internal accounting controls found during its audit.

[121] 12 C.F.R. § 9.18(5)(ii).

[122] 12 C.F.R. § 9.18(b)(5)(iv).

[123] 15 U.S.C. § 80a-29(a); 17 C.F.R. §§ 270.30a-1, 270.30b1-1.

[124] *See* Item 77B and accompanying instructions to Form N-SAR, Investment Company Act Release No. 14299 (Jan. 4, 1985), 50 FR 1442; AUDIT AND ACCOUNTING GUIDE, Audits of Investment Companies 164 (Am. Inst. of Certified Pub. Accountants 1987).

[125] ***See supra*** notes 117,118,119,120 and accompanying text.

[126] *See* 12 C.F.R. § 9.18(b)(5).

B. Recommendations for Reform

Today, plan participants receive far less information about the investment objectives and policies, performance, investment managers, fees, and expenses of their investment options than do investors who directly purchase securities issued by investment companies or other issuers. The Division believes that disclosure to plan participants who direct and bear the risk of their investments should be improved. Therefore, we recommend that the Commission send to Congress legislation that would remove the current exemption from Securities Act registration in section 3(a)(2) for interests in pooled investment vehicles consisting of assets of participant-directed defined contribution plans. Further, we recommend that the legislation amend the federal securities laws to require the delivery of prospectuses for the underlying investment vehicles to plan participants who direct their investments. We also recommend legislation that would amend the Exchange Act to require the delivery of semiannual and annual shareholder reports for the underlying investment vehicles (other than registered investment companies) to these plan participants. Finally, we recommend that the rules under the Investment Company Act be amended to require the delivery of semiannual and annual reports of underlying registered investment companies to these plan participants.

Two factors prompted us to reconsider the Securities Act exemption for interests in pooled investment vehicles for participant-directed defined contribution plans. The historical reasons justifying the securities law exemptions of pooled vehicles for employee benefit plan assets -- that "sales" are made to sophisticated employers and that the employers bear the risk of loss -- are both inapposite in the case of participant-directed defined contribution plans. Second, the current ERISA requirements and banking regulations do not provide investors with information comparable to that provided under the securities laws. Although plan fiduciaries are held to a "prudent person" standard under ERISA with respect to.the initial and continued suitability of the investment alternatives designated by the plan sponsor in a participant-directed plan, participants nonetheless must make the final investment decision in such plans.[127] Participants in these plans are in a position similar to that of an ordinary investor, but *without* the benefits of the disclosure provided under the federal securities laws.

Accordingly, we recommend that the Commission seek legislation to amend section 3(a)(2) of the Securities Act to remove the exemption from registration for interests issued by those collective trust funds and separate accounts in which participant-directed defined contribution plan assets are

[127] *See infra* notes 133-137 and accompanying text (ERISA prudence requirements).

invested.[128] We only recommend removal of the exemption from registration for interests in pooled investment vehicles, not the exemption for the participant's interest in the plan itself. We further recommend that the securities laws be amended to require the delivery of prospectuses of underlying collective trust funds, separate accounts, and registered investment companies to the participants in these participant-directed plans. These recommendations would provide plan participants who make their own investment decisions with the benefit of the disclosures required under the federal securities laws. As we have discussed above, these disclosures are far more timely and comprehensive than those currently required under ERISA or the banking regulations. Moreover, those making these disclosures would be subject, for the first time, to civil liability for material misstatements and omissions under sections 11 and 12(2) of the Securities Act.[129] These pooled investment vehicles, however, otherwise would remain subject to ERISA, the Internal Revenue Code, and, with respect to bank collective trust funds, the Comptroller's regulations.

Subsequent to their initial decision to invest in securities, participants have a continuing need for information to evaluate their investments and decide whether to maintain or reallocate them. Essential information for this ongoing investment review is contained in the issuers' current prospectuses and shareholder reports. For this reason, the Division believes that the federal securities laws should be amended to require delivery of prospectuses of underlying collective trust funds, separate accounts, and registered investment companies to plan participants when they reallocate their investments. In addition, to ensure that participants receive important financial information in connection with monitoring their investments, the Division recommends that the periodic reporting exemption in the Exchange Act for collective trust funds and separate accounts be deleted and that those pooled investment vehicles be required to transmit to participants the same information required of investment companies under the shareholder reporting provision of the Investment Company

[128]We conclude that it is appropriate to continue the securities law exemptions for pooled investment vehicles, and interests therein, that consist exclusively of assets of defined benefit plans and defined contribution plans that do not provide for participant direction. ERISA imposes duties and liabilities on sponsors and managers of these plans that relieve the individual participant of much of the responsibility for the management of his or her assets under the plan. With respect to defined benefit plans in particular, the employers bear the investment risks, and the plans are subject to certain ERISA funding and liability requirements that are not applicable to defined contribution plans. Unlike defined contribution plans, defined benefit plans generally are insured by the PBGC.

[129]We believe that both a plan, and its participants on a derivative basis, should have a cause of action against issuers who violate these sections – in the same way as any other issuer is liable. The plan sponsor or fiduciaries should be liable for an issuer's material misstatement or omission only if it reasonably should have known about it.

Finally, the rules under the Investment Company should be amended to ensure that all beneficial owners in registered investment companies receive semiannual and annual reports.

V. Substantive Regulation of Pooled Investment Vehicles

We also considered whether section 3(c)(11) of the Investment Company Act should be amended to require collective funds and separate accounts to register as investment companies. To analyze this issue, we compared the three regulatory frameworks. This section compares certain key areas of substantive regulation under the Investment Company Act, **ERISA,** and the Comptroller's regulation 9. We conclude that while the protections provided by the Investment Company Act probably are somewhat greater, **ERISA** adequately protects participants in both defined benefit and defined contribution plans, including participant-directed defined contribution plans. Requiring these pooled investment vehicles to register under the Investment Company Act would be costly and disruptive. Accordingly, we do not recommend that these collective trust funds and separate accounts be required to register under the Investment Company Act.

The three regulatory frameworks impose differing sets of requirements and apply to groups of persons with differing relationships to employee benefit plan assets. Despite those differences, in many key areas of investor protection investment companies, bank collective funds, and insurance company separate accounts holding plan assets are subject to comparable (though not identical) regulation.

A. Fiduciary Standards

The Investment Company Act imposes several somewhat general fiduciary duties on certain persons in connection with their investment company activities. ***An*** investment company's investment adviser has a fiduciary duty with respect to any compensation, including its management fee, it receives from an investment company or its shareholders, Section 36(b) allows the Commission or any shareholder to bring an action for breach of this fiduciary duty.[131] Section 36(a) authorizes the Commission to bring an action for injunctive or other judicial relief against any officer, director, investment adviser, or principal underwriter of an investment company for breach of fiduciary duty involving personal

[130]**As further discussed supra at notes 110-112 and accompanying text, the Investment Company Act shareholder reporting provisions,** section 30(d) **and rule 30d-1 thereunder, require a registered investment company to provide semi-annual and annual reports containing basic financial information about the fund.** ***See*** **15 U.S.C. § 80a-29(d); 17 C.F.R. § 270.30d-1.**

[131]**15 U.S.C. § 80a-35(b).**

misconduct.[132] Further, the antifraud provision of the Investment Advisers Act of 1940 also protects investment companies and their shareholders against fraudulent, deceptive, and manipulative conduct by investment advisers.[133]

ERISA contains an explicit fiduciary requirement that obligates an ERISA plan fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man [sic] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[134] The plan fiduciary must ensure that the plan's investments are diversified to minimize the risk of large losses, unless it is clearly prudent not to do so,[135] and generally act in accordance with the plan documents.[136] A plan fiduciary must monitor the performance and suitability of plan investments.[137] A plan fiduciary also may be liable for another fiduciary's breach of fiduciary duty under certain circumstances.[138]

ERISA preempts state civil law with respect to employee benefit plans.[139] Participants, therefore, cannot bring a common law action for breach of fiduciary duty against a plan fiduciary. Participants, beneficiaries, fiduciaries, and the Secretary of Labor may bring civil actions under ERISA for any breach of fiduciary duty, including breaches of the prohibited transactions provisions.[140]

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[132] 15 U.S.C. § 80a-35(a).

[133] 15 U.S.C. § 80b-6.

[134] 29 U.S.C. § 1104(a)(1)(B).

[135] 29 U.S.C. § 1104(a)(1)(C).

[136] Generally, a fiduciary must consider certain factors in the prudent performance of its investment duties, including the diversification of the plan's assets, liquidity and current return, and projected return. 29 C.F.R. § 2550.404a-1.

"ERISA does not set forth specific requirements with respect to the type of information that pooled investment vehicles must provide to the plan sponsors.

[138] 29 U.S.C. § 1105(a).

[139] 29 U.S.C. § 1144(a).

[140] 29 U.S.C. §§ 1132(a)(2)-1132(a)(3). See generally Daniel Candee Knickerbocker, *Trust Law with a Difference: An Overview of ERISA Fiduciary Responsibility*, 23 REAL PROP. PROB. & TR. J. 633 (1988) (comparing fiduciary duties and liabilities under ERISA and traditional trust law). Recently, the Department of Labor filed suits against employers and other fiduciaries, charging them with violating their fiduciary responsibility in purchasing retirement annuities for their employees from a subsidiary of bankrupt First Executive Corp. *See* *U.S. is Suing AFG on Buying Annuities From Executive Life*, WALL ST. J., July 12,1991, at C8; Robert Rosenblatt, *U.S. Challenges Pension Switching*,
(continued...)

The Secretary is required to assess a civil penalty against a fiduciary for breaching a fiduciary duty or engaging in a prohibited transaction and may also assess a civil penalty against a party in interest for violations of the prohibited transactions provisions.[141] The Internal Revenue Code also imposes excise taxes on "disqualified persons" who engage in prohibited transactions with a plan.[142]

ERISA imposes strict responsibilities and limitations on banks and insurance companies as fiduciaries with respect to plans whose assets are invested in collective funds or separate accounts. ERISA defines as a plan fiduciary any person who exercises discretion with respect to the management of a plan or its assets, renders investment advice to a plan for a fee (direct or indirect), or has discretion with respect to the administration of a plan.[143] This generally includes the plan sponsor, its directors, and certain of its officers and employees. A fiduciary must act with respect to the plan solely in the interest of the plan participants and for the exclusive purpose of (i) providing benefits to the participants and (ii) defraying reasonable expenses of administering the plan.[144]

ERISA limits a plan fiduciary's fiduciary responsibility to the specific plan assets over which it exercises discretion or has the responsibility that makes it a fiduciary.[145] When a plan invests in an entity, the "plan assets" of the plan generally include its investment but not, solely by reason of that investment, any

[140](...continued)
L.A. TIMES, June 13,1991, at Al; Frank Swoboda, *U.S. Tests Rules on Annuities Purchased by Pension Funds*, WASH. POST, June 13,1991, at B11; *see* also Ann Hagedorn & Suein L. Hwang, *Unisys Sued for Investing in Executive Life*, WALL ST. J., June 17, 1991, at B3 (suit brought by plan participants alleging imprudent investments).

[141]29 U.S.C. §§ 1132(i), 1132(l).

[142]The Internal Revenue Code contains a similar set of prohibited transactions provisions and statutory exemptions with respect to plans qualified under section 401. Most of the transactions prohibited under ERISA give rise to excise taxes under the Code. However, the Code imposes the excise taxes on a smaller class of persons. *Compare* 26 U.S.C. § 4975(c) (prohibited transactions) *with* 29 U.S.C. § 1106 (prohibited transactions).

[143]29 U.S.C. § 1002(21)(A). See also 29 C.F.R. § 2510.3-21(c)(1) (definition of "investment advice").

[144]29 U.S.C. § 1104(a).

[145]Exemptions From Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers, and Banks, Prohibited Transaction Exemption 75-1, 40 FR 50845, 50846 (1975) [hereinafter PTE 75-11. *See* 29 C.F.R. § 2510.3-21 (definition of "fiduciary"). A person is a fiduciary only with respect to those plan assets over which that person exercises any fiduciary responsibility. That person, however, is a party *in interest* with respect to all plan assets. PTE 75-1, supra, at 50846. For a discussion of "party in interest," *see infra* note 155 and accompanying text.

of the underlying assets of that entity.[146] When a plan invests in an equity interest of a company that is not an operating company and the security is neither a publicly-offered security nor a security issued by a registered investment company, however, the plan's assets include both the equity interest and an undivided interest in the underlying assets of the entity that issued the equity interest.[147] ERISA makes any person exercising authority or control over the management or disposition of the underlying assets of that entity, and any person who provides investment advice with respect to those assets for a fee (direct or indirect), a fiduciary of the investing plan, subject to all of the duties and liabilities imposed upon plan fiduciaries.[148] When a plan invests in a collective trust fund or a pooled separate account, plan assets include both the interest issued by the entity and an undivided interest in each of the underlying assets of the entity.[149] Consequently, any person who exercises authority or control respecting the management or disposition of the underlying assets of the collective trust fund or separate account, and anyone providing investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the plan. These persons could include a bank's or insurance company's board of directors or investment committee, or a bank's trust department.

Regulation 9 describes national banks as fiduciaries with respect to the employee benefit plan assets they invest in their collective trust funds but, unlike the Investment Company Act and ERISA, does not enumerate specific fiduciary duties. Regulation 9 does not provide specific remedies for breach of fiduciary duty with respect to investments in collective trust funds. Nonetheless, the Comptroller of the Currency may fine a national bank or an affiliated party for

[146] 29 C.F.R. § 2510.3-101(a)(2).

[147] *Id.* If equity participation in the entity by benefit plan investors is not significant, plan assets include only the equity interest in the entity. Id.

[148] *Id.*

[149] 29 C.F.R. § 2510.3-101(h)(1). The underlying assets of separate accounts maintained solely in connection with guaranteed investment contracts under which amounts payable to the plan are not affected in any manner by the investment performance of the separate account are not plan assets.

By contrast, when a plan invests in securities issued by an investment company, those securities -- but not any assets of the investment company – become plan assets. 29 U.S.C. § 1101(b)(1). Accordingly, neither the investment company nor its investment adviser or principal underwriter is treated as a fiduciary of such plan under ERISA. 29 U.S.C. § 1002(21)(B). This special treatment of investment companies reflects Congress' perception that the Investment Company Act already subjects investment companies to extensive fiduciary regulation. *See* William M. Tartikoff, *Treatment of Mutual* Funds *Under* ERISA, 1979 DUKE L.J. 577, 581 (citing pertinent legislative history).

violating the banking laws or regulations constituting a breach of fiduciary duty.[150]

B. Prohibitions Against Self-Dealing: Investment Company Act, ERISA, and Regulation 9

The Investment Company Act extensively restricts self-dealing between investment companies and their affiliates. As discussed in detail in Chapter **12,** section 17 restricts three broad categories of affiliated transactions to protect investors from a variety of conflicts of interest that may arise when a passive pool of assets is within the reach of interested parties. The Investment Company Act prohibits or restricts transactions in which an affiliate (or an affiliate of an affiliate): **(1)** purchases securities from or sells securities to, or borrows money or property from, the investment company ("principal transactions"); (2) jointly participates in a transaction with the registered investment company ("joint transactions"); and **(3)** acts as broker or agent for the investment company ("agency transactions").[151] Further, to prevent an affiliate from unloading or "dumping" unwanted securities into an investment company, section 10(f) of the Investment Company Act generally prohibits an investment company from purchasing securities in an underwriting in which any affiliated person participates as a principal underwriter.[152] Under rule 10f-3, investment companies may purchase securities from a syndicate containing an affiliate if certain safeguards are met.[153]

To protect a plan's assets against abusive practices by persons in a position to control those assets, ERISA prohibits plans from engaging in transactions with two types of persons: "parties in interest" and "fiduciaries." "Party in interest" is defined broadly to include many persons who, by virtue of a financial interest in a plan's operations, or some relationship to a plan or another party in interest, might be in a position to exert improper influence over the plan to the detriment of the plan and its participants.[154] Plan investment managers, administrators, and other fiduciaries are parties in interest and thus subject to the prohibitions

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[150] 12 U.S.C. § 93(b).

[151] 15 U.S.C. § 80a-17.

[152] 15 U.S.C. § 80a-10(f).

[153] 17 C.F.R. § 270.10f-3.

[154] *See* 29 U.S.C. § 1002(14)(A) (definition of "party in interest"). Parties in interest with respect to a particular plan include the sponsors, fiduciaries, and service providers of the plan and all officers, directors, employees, and ten percent shareholders of the plan sponsor and the plan. 29 U.S.C. § 1002(14)(A)-(I).

applicable to all parties in interest as well as certain prohibitions specifically governing only fiduciaries.

The coverage of ERISA's self-dealing and conflict of interest prohibitions is similar but not identical to those of the Investment Company Act. These differences exist partly because the Investment Company Act self-dealing prohibitions affect transactions between the investment company and any "affiliated person," a defined term broader in some respects and narrower in others than "party in interest."[155] For example, the owner of five percent of the outstanding voting shares of an investment adviser must comply with the Investment Company Act self-dealing restrictions, whereas only a ten percent or larger shareholder of a plan sponsor would be subject to ERISA's *per se* prohibited transactions provisions. On the other hand, any custodian of a plan and any person who provides services to a plan, such as a broker, is a party in interest with respect to that plan, while a person who provides custodial or brokerage services to an investment company is not, for that reason alone, an affiliated person of the investment company. Differences in coverage also exist because the Investment Company Act does not distinguish between fiduciaries and other affiliated persons with respect to its self-dealing prohibitions, while some of ERISA's prohibitions apply only to "fiduciaries," a defined term covering plan trustees, investment advisers, and administrators.[156]

ERISA's core prohibitions, contained in section 406, are generally comparable to many of those in the Investment Company Act. Under section 406(a), a plan may not engage in a transaction with a party in interest that would directly or indirectly constitute: a sale, exchange, or lease of any property; a loan of money or other extension of credit; furnishing goods, services, or facilities; a transfer to or use by or for the benefit of a party in interest of any assets of the plan; or an acquisition on behalf of the plan of employer securities or employer real property in excess of prescribed limits which, for defined benefit plans, would be 10% of plan assets.[157] As with the Investment Company Act, ERISA permits affiliates to provide certain services to the fiduciary client. Section 406(b) prohibits a plan fiduciary from dealing with plan assets for its own interest or account, acting on behalf of any party whose interests are adverse to the plan's or participants' interests in a transaction involving the plan, or receiving any consideration (*i.e.*, kickbacks) from any party dealing with the plan in connection with a transaction involving assets of the plan.

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[155] *Compare* 15 U.S.C. § 80a-2(a)(3) with 29 U.S.C. § 1002(14) (definitions of "affiliated person" and "party in interest").

[156] *See* 29 U.S.C. §§ 1002(21)(A), 1106(b).

[157] *See* 29 U.S.C. § 1106(a)(1).

Regulation 9 subjects bank collective funds to some self-dealing restrictions. A national bank maintaining a collective trust fund may not sell to or purchase from the collective trust fund securities or other property, although affiliates of the bank are not prohibited from making such purchases or sales.[158] Banks may purchase securities on behalf of their collective trust funds in an underwriting in which an affiliate participates, if a majority of the bank's outside directors approves the transaction.[159] Even if a bank fails to obtain approval of the outside directors, it may "cure" a self-dealing underwriting transaction through disclosure.[160]

1. Principal Transactions: Prohibitions and Exceptions

Section 17(a) of the Investment Company Act prohibits an affiliate of an investment company, acting as principal, from knowingly purchasing or selling securities or property from or to the investment company. It also prohibits affiliates from borrowing from the investment company. The Commission has adopted rules providing certain exceptions from these prohibitions.[161] In addition, under section 17(b), the Commission may exempt a proposed transaction if its terms are fair and reasonable, involve no overreaching by any person, and are consistent with the general purposes of the Investment Company Act.

Notwithstanding the prohibitions of section 17(a), section 17(c) permits an affiliated person, in the ordinary course of business, to purchase from or sell to an investment company merchandise, enter into lessor-lessee relationships with the investment company, and furnish services incident thereto. Nevertheless, the Investment Company Act and the rules thereunder protect against affiliated persons engaging in self-dealing with respect to service contracts with investment companies. As earlier noted, an investment adviser and its affiliated persons have a fiduciary duty with respect to any compensation, including any fees for services it receives from an investment company or its shareholders. Under section 36(b) of the Investment Company Act, both the Commission and shareholder may sue

[158] 12 C.F.R. § 9.18(b)(8)(i).

[159] The Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102(a), 101 Stat. 552, 564 (1987) (codified at 12 U.S.C. § 371c-1), added Section 23B to the Federal Reserve Act, which prohibits the purchase of securities by a member bank or its subsidiary, either as principal or fiduciary, from any underwriting in which an affiliate is a "principal underwriter" of those securities, unless a majority of the outside directors of the bank approves the purchase.

[160] OFFICE OF THE COMPTROLLER OF THE CURRENCY, Trust Banking Circular No. 19 (Sept. 25, 1981), 5 Fed. Banking L. Rep. (CCH) ¶ 59,309.

[161] *See* Chapter 12.