Securities Rules for Retirement Plans

By Robert J. Toth, Jr.

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The regulatory schemes governing the registration and sales of securities and the regulatory scheme governing retirement plan investments have historically developed separately from each other. The SEC and the U.S. Department of Labor's, Employee Benefits Security Administration (the "EBSA") had worked independently of each other for decades, with their regulatory paths only occasionally crossing. Indeed, not only had there been little coordination between the SEC and EBSA, there had always been a bit of regulatory animosity between the two agencies.

The compliance marketplace has likewise developed separately, as the typical securities compliance staffs in financial services organizations have little relationship with the ERISA compliance staffs. The word "compliance" actually has greatly different meanings for the two different kinds of staffs.

But now, a substantial percentage of the value of publicly traded U.S. stocks is held by retirement plans[1]. This has been drawing the attention of SEC. As early as 2003, the SEC stepped over the regulatory line by proposing that mutual funds being held by 401(k) participants be required to provide their prospectuses directly to these plan participants. This mistaken effort ignored the well-established disclosure scheme developed over the years by the EBSA to protect participant rights, and eventually went nowhere. It also became clear, however, that the ability to properly regulate the growing complexity of investment products sometimes being used by retirement plans could often be beyond the expertise and experience of EBSA staff.

There have since then been a number of efforts by the SEC to more directly regulate individual account plans like 401(k) plans. For example, the SEC issued Rule 22c2 , 17 CFR 270.22c-2, under the Investment Company Act of 1940, which treated 401(k) participants as "shareholders" for purposes of imposition of market timing, frequent trading and redemption rules. Rule 22c2 did cause substantial expense in the 401(k) market, where vendors needed to put into place hugely expensive data collecting and reporting schemes to track, monitor, report and eventually control the trading practices of individual 401(k) participants.

The SEC and the EBSA are beginning now to take a quite different tack, and have begun to regularly collaborate where their interests intersect. For example the SEC and the EBSA conducted joint efforts to

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uncover "contingent compensation" in retirement plans; the SEC and the DOL entered into a July 29, 2008 Memorandum of Understanding in which each committed regional staff to cooperating on retirement plan investigations where securities law issues were involved; and the SEC and the EBSA cooperated in holding hearings on target date funds June 18, 2010 and issued joint guidance on May 6, 2010 for such funds being bought by individual account retirement plans. The EBSA has issued two new sets of regulations related to investment fee disclosure and service provider fee disclosure for retirement plans in consultation with the SEC, using in its regulations many of the concepts and standards used by the SEC for years; see 29 CFR 2550.408b-2 and 29 CFR 2550.404a–5.

Clearly, the SEC and the DOL have recognized their joint interests in many areas involving retirement plans; but the SEC often appears to be blurring its jurisdictional lines in many of these efforts. This will cause the various compliance staffs to act accordingly, and begin to be more aware of these areas of cooperation between the two regulatory agencies.

The regulatory schemes governing the registration and sales of securities and the regulatory scheme governing retirement plan investments have historically developed separately from each other.

These joint activities are impacting the compliance staffs of securities and financial services firms. Such staffs of these companies are already familiar with a number of the retirement plan rules which apply to their practices, particularly in the area of sales of retirement investment products. For example, FINRA's rules with regard to the supervision of registered reps who also sell non-registered products to 401(k) plans has resulted in the establishment of substantial compliance procedures related to these responsibilities, including non-cash compensation practices and monitoring sales practices related to those products.

However, the SEC's activities are creating a pressing need for securities compliance staffs to become more familiar with retirement plans and their operations. One of the steps in this process is to understand how the federal securities laws actually apply to individual account retirement plans which permit plan participants to direct investments.

The following describes some of the more common retirement plans in which the SEC seems interested, and outlines the basic securities laws which apply to them. [2]

Individual Account Plans

The first step to understanding retirement plan securities regulation is that the rules which apply to the regulation of a participant's *interest in* retirement plans are a bit different from the rules that apply to the *sale or purchase of investment products to* such plans. Though the bases for these rules are often similar, they are much different in their application.

We will explore two of the most common arrangements where plan participants have the right to invest their own contributions into the plan, and to direct those funds between a variety of variable and non-variable investment funds. These rules will apply regardless of the type of investment product purchased by the plan, whether they are annuity contracts, mutual funds, or pooled accounts. These two types of plans are the 401(k) plan and the 403(b) plan.

401(k) plan: Interests as securities.

401(k) plans are by far the most prevalent individual account plan offered by employers. These plans permit employees to make pre-tax deferrals and post tax Roth contributions, and permit employers to make tax deferred matching contributions as well as discretionary profit sharing contributions. More recently, employers have been permitted to enroll employees automatically into these plans using the "negative consent" process, by which the deferrals are automatically made to these arrangements upon notice, with the right of the employee to opt out automatically at any time.

In spite of this "automatic enrollment" feature, 401(k) plans are considered "cash or deferred arrangements," where it is the option of the employee to participate in the plan or not. As such, it is considered a voluntary "purchase" of the investments in the 401(k) plan, which then implicates security law regulation

There is a common misconception that 401(k) plans are exempt from securities law regulation. This arises from the fact that most such plans themselves are exempt from registration as a security under the Securities Act of 1933 (“the ’33 Act”), and that most of these plans have the ability to buy non-registered variable investment products. This sort of “grace” granted by the securities law has had a sort of “lulling” effect, from which many are now being rudely awakened. The truth is that there is only partial relief from direct regulation by the securities laws for these plans.

The analysis begins with the definition of a security under the ’33 Act and the Securities Exchange Act of 1934 (“the ’34 Act”), which is extraordinarily broad. A 401(k) plan participant who elects to defer a portion of his or her paycheck into a plan, where he or she has the ability to choose to invest those funds between a number of variable investments within the plan, is considered to be buying a security. Their “interest” in the plan is actually the security, akin to purchasing interests in a collective trust. These interests are purchased by voluntary contributions which are made into funds maintained and managed by the plan. See, for example, SEC Release No. 33-6281 (Jan. 15, 1981). This makes them securities under the broad definitions used by the ‘33 and ‘34 Acts.

Though interests of a 401(k) plan are securities, these interests are generally exempt from the securities laws’ onerous registration requirements. This is accomplished by virtue of a statutory exemption (for the ‘33 Act, found under Section 3(a)(2)) for retirement plans which is either “qualified” under Internal Revenue Code Section 401(a), (which includes 401(k)) or is a governmental plan, under which it is “impossible” for the assets to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries.

There are some 401(k) plans which allow participants to elect to invest in shares of the plan sponsor’s stock. The exemption from registration is not available to these plans. If a firm has one of these plans, it will find that these plans actually will be required to register their interests as securities, using a Form S-8.

Exemption from registration does not mean, however, that the 401(k) interests are exempt from the rest of the federal securities laws. Importantly, this means that the “sale” of these interests is still subject to the antifraud provisions of Rule 10b-5 of the ’34 Act, 17 C.F.R. § 240.10b-5. This gives the SEC much of the statutory authority it needs to engage in a number of activities related to regulation of certain parts of these plans, and for which the compliance professional needs to prepare.

This also means that compliance professionals in organizations which provide products or services to retirement plans need to be concerned about fraudulent sales activities in either their own company’s plans, or the plans to which they provide services or products. It will be important to know that the SEC has the ability to question and investigate a number of practices related to these plans, including the manner in which the products are sold to plans, and the manner in which “interests” are represented to plan participants.

The SEC and the [Department of Labor’s Employee Benefits Security Administration] … have begun to regularly collaborate where their interests intersect.

Company practices with regard to these plans should be on the typical compliance checklist. Those who have supervisory responsibility for registered reps should make sure those reps’ practices related to retirement plans are also properly supervised.

403(b) Plans: Interests are NOT Securities

403(b) plans, are individual account retirement plans that are offered to employees of tax exempt organizations and public schools and universities. They are treated completely differently from 401(k) plans, and lay within the direct jurisdiction of the securities compliance professional. Many compliance officers work for vendors who sell investments and services to these kinds of plans. 403(b) plans are, generally, individual account plans which are very similar to 401(k) plans in key respects. But they can be offered only by non-profit employers which are tax-exempt under Section 501(c) (3) of the Internal Revenue Code, or state-run educational organizations, such as public school districts or public universities and community colleges.

These plans may collectively hold nearly $1 trillion in assets, a large part of the retirement marketplace.

Some of these plans have been in existence for 80 or 90 years, and have substantial assets. They can hold the same kind of contributions as 401(k) plans. A significant number of these plans are not subject to ERISA's fiduciary obligations and are outside of the jurisdiction of the DOL's EBSA because of either a regulatory exemption issued in 1976, or because they are governmental plans that fall outside of the jurisdiction of ERISA. One of the most striking aspects of the 403(b) plan, from the compliance officer's point of view, is that, with the exception of certain church-sponsored 403(b) plans, these funds can only be held in custodial accounts which invest in shares of investment companies registered under the Investment Company Act of 1940 ("the '40 Act"), or in annuity contracts issued by insurance companies.

The first and most important securities law distinction is that 403(b) "plans" do not have the exemption from registration which is enjoyed by 401(k) plans. This is because the exemption from registration under Section 3(a)(2) of the '33 Act is for "stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954 26 USCS § 401 plans." 403(b) plans do NOT meet the requirements of Section 401, (as a matter of fact, Section 3(a)(2) specifically excludes 403(b) arrangements from this definition) and there is not another exemption which applies to 403(b) contracts if they contain variable investment accounts. 401(k) plans, on the other hand, are actually a subset of 401(a) plans.

The likely reason that 403(b) arrangements are not included in the exemption is that they have been designed in the past as "individual pensions," purchased by individuals for themselves through their employers. Under these arrangements, employers have typically had little control over the investments in these contracts.

This lack of an exemption has caused most 403(b) arrangements to be structured as being individual purchases of the actual security, rather than as a purchase of an "interest" in a plan which offers pooled investment accounts (like a 401(k) plan). If these arrangements were designed as a plan (for investment purposes), the 403(b) plan itself, along with attendant "interests, would have to be registered-probably using the Form S-8.

Those 403(b) assets which can be invested only in annuity contracts and in custodial accounts which hold mutual fund shares must then, because of the lack of exemption, be registered securities if they are variable investments. This means that the typical 401(k) investment, such as a cash account in a trust, an interest in a non-registered collective trust, an ETF trust interest, or a non-registered group variable annuity contract *cannot* be used as a 403(b) investment.

With there being no "plan" exemption, and with the individual participant directly purchasing the security (instead of purchasing a plan interest which then purchases the security), securities laws treat that participant as the owner of the security-even if the group annuity contract or group custodial account "owner" is the employer. This then results in all of the rights under the security-such as proxy voting, Rule 10b-10 notices (i.e., confirmations) and prospectus delivery-running to the plan participants themselves. Compare this with the 401(k) plan, where the trustee of the plan is viewed as the owner of the security to whom all rights flow.

This difference has a very practical impact that can create liability directly affecting the compliance professional. The compliance professional is likely well familiar with the application of all of these rules when 403(b) investment products are purchased by an individual who works through a licensed professional. But more and more, the marketplace is designing 403(b) plans to fit on 401(k) administrative platforms, as many of the administrative rules governing each of these plans are becoming more closely aligned. These platforms offer economies of scale, which are generally unavailable on traditional 403(b) platforms. The related sales practices of 403(b) plans are now also "morphing" to more closely resemble the 401(k) sales practice.

The compliance problem arising from this change in practices is that the *legal* basis of the 403(b) plan has not changed. Participants in 403(b) plans are still required to receive prospectus delivery in the time and manner in which they would if they were retail purchasers of those investments, and the proxy voting rights related to those investments must be passed through to them. Often, 401(k) platforms may not provide this sort of capacity, as 401(k) plan participants typically have no such rights. "Enrollment" in a 403(b) plan is thus actually much different from enrollment in a 401(k) plan, for example, because of the prospectus delivery rules.

It can be a critical error – and a very expensive one -- to fail to provide the required disclosures and

other rights to 403(b) plan participants, as the 12 month right of recission is one of the remedies available to those shareholders who have not properly received prospectus delivery.

The compliance challenge for 403(b) plans is thus much different from that of 401(k) plans. As explained above, it arises from removing the 403(b) plan from its historical control environment and into the much less controlled environment of the 401(k) practice.

Confusion over 401(k) jurisdiction

As much regulatory authority as the SEC has over retirement plans, that authority is still limited in some important respects, especially with regard to 401(k) plans. There appears to be some confusion within the SEC staff as to the nature of the 401(k) plan, and the SEC's proper role. This in turn will create continuing challenges for the compliance professional.

This confusion arises from the SEC's treatment of 401(k) plans as "omnibus" accounts for purposes of Rule 22c2 and the proposed 12b-1 rule changes, see 75 FR 47064, August 4, 2010. In each of these cases, the SEC has asserted that the 401(k) plan participant is the "shareholder" for whom the trustee is merely holding mutual fund shares. This approach, besides creating severe compliance and administrative problems, seems to have little legal basis.

Legally, as explained earlier, a 401(k) participant has no right to any asset under the plan. The plan is an entity to itself, as is the trust created under it. ERISA only grants to participants a beneficial interest in the assets held in the plan. The plan can grant, and remove, any ability of a participant to trade between investments within the plan, and has the ultimate authority to override any participant investment direction. Many of the mutual funds under these plans are held in pooled accounts, where there is no share accounting, but unit value accounting. Unit value accounting means that the collective pool of mutual fund shares and any un-invested cash are divided into "units" which are then valued.

These are not elements which constitute the typical omnibus account at, for example, a broker dealer. These plans are not merely holding securities in street name on behalf of participants of the plan, but actually own all rights attendant to those shares and may or may not, at their own choosing, grant any of those rights to plan participants. But even where such rights are granted, fiduciaries have the duty to review the exercise of any such right, and deny it if its exercise is imprudent.

This approach, if successfully maintained by the SEC, will create significant challenges for the securities compliance officer. Much of the burden of this expanded regulatory role being played by the SEC will fall upon those who currently are responsible for administering the SEC's rules: the securities compliance staff, This likely means there will be an increased compliance responsibility for these staffs with regard to their own 401(k) plans, as well for employers of compliance officers who also act as vendors for 401(k) plans.

The securities rules governing retirement plans have long been well below the radar for the typical securities compliance staff. That is now all rapidly changing, and these rules can now directly impact the regular compliance practice.

ENDNOTES

1 For example, a report by Robert Shapiro for NDN (a Washington DC think tank) claims at least 40% of the US equity markets are controlled by retirement plans

2 We will not go into the variety of ERISA fiduciary rules which apply to these plans, and the manner in which they are becoming increasingly similar to securities regulation, nor will this delve into the "prohibited transaction" regulations, which serve as the ERISA enforcement backbone of these developing rules.

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