

Financial Regulation and Consequences on America's Retirement Savings

The Defined Contribution Institutional Investment Association (DCIIA)¹ commends the initiative taken by Congress to secure America's financial system in the Restoring American Financial Stability Act (S. 3217) and Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). However, DCIIA believes that certain provisions contained in the bills, if enacted, would have adverse unintended consequences that would negatively impact participants in 401(k), 457 and other defined contribution plans.

This summary strives to clearly set out the impact that the current provisions in the Senate and House bills could have on stable value funds and other defined contribution plan investment options, as well as the adverse implications this legislation could have for the millions of main street investors that rely heavily on their 401(k) plan savings and stable value funds.

Stable Value Investments in Today's Defined Contribution Plans

Stable value is the most prevalent conservative investment option in 401(k) plans. As shown in the table below, participants invested in stable value funds have consistently and significantly outperformed money market funds annually.²

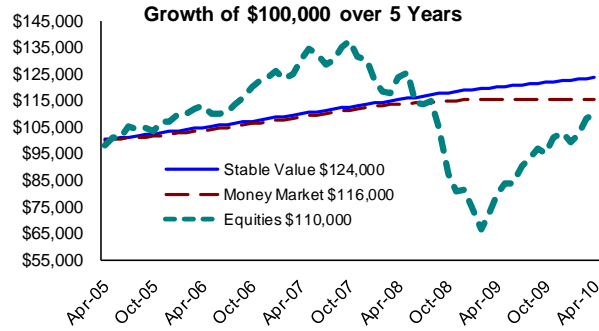
<i>4/30/2010</i>	<i>Hueler Stable Value Pooled Index</i>	<i>Lipper Money Market Average*</i>	<i>Stable Value Outperformance</i>
<i>1 Year Return</i>	3.07%	0.52%	2.55%
<i>3 Year Return</i>	4.01%	2.42%	1.59%
<i>5 Year Return</i>	4.28%	3.29%	.99%

The following chart shows growth of \$100,000 for the five-year period ending 4/30/2010 when invested in stable value as separately compared to money market funds and to equities.³

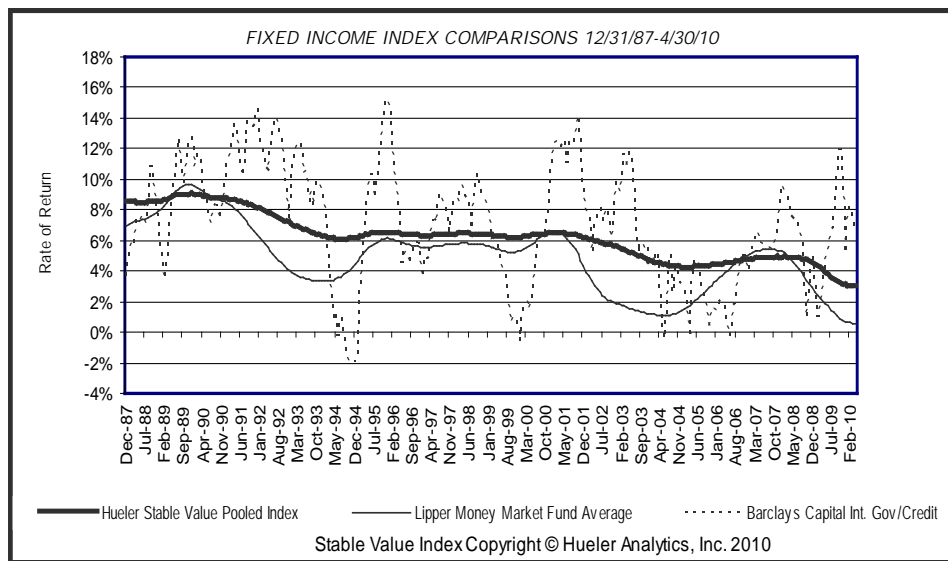
¹ DCIIA is a recently formed non-profit trade association dedicated to enhancing the retirement security of American workers. DCIIA members include investment managers, consultants, record keepers, insurance companies, plan sponsors and others committed to improving retirement outcomes for American workers by advocating for better defined contribution plan design and institutional investment management approaches.

² Source: Hueler Stable Value Pooled Fund Index and Lipper Money Market Average

³ Indices used in comparison of growth chart: Hueler Stable Value Pooled Fund Index, Lipper Money Market Average, S&P 500



As reflected in the chart below, stable value funds are designed to deliver the liquidity of money market funds with returns similar to intermediate-term bonds (without the corresponding market volatility).



Plan participants who have invested in stable value funds have directly benefited not only from the increased returns over money market funds, but also have been able to protect their hard-earned retirement savings from losses during the recent extreme market volatility. These return and principal protection benefits delivered via stable value funds are particularly important for the rapidly growing number of defined contribution plan participants nearing or in retirement. Notably, many retirees retain their assets in 401(k) plans to continue investing in stable value funds.

Here are some additional key facts about stable value:⁴

- Stable value funds hold nearly \$650 billion in 401(k) assets, roughly a quarter of all 401(k) assets. This is quadruple the amount currently invested in target-date funds in DC plans.
- The historical allocation to stable value in 401(k) plans typically ranges from about 15% for workers in their 20s to just over 35% for workers in their 60s. This reflects the demand for stable value as a

⁴ Source: Stable Value Investment Association, ICI, EBRI.

vehicle to help older workers and retirees mitigate market risk and establish sufficient assets to fund retirement income needs.

- Stable value assets are spread across nearly 170,000 DC plans in the U.S., the majority of which are small plans, representing Main Street businesses across America and millions of American workers.

Usage of OTC Derivatives in Defined Contribution Plans to Save Costs and Increase Returns

There are several important uses of “swaps” in defined contribution plans that might be impacted unintentionally by the proposed legislation. Stable value investment contracts are used to allow fixed income investments in stable value funds to be maintained at book value. Additionally, swaps can play a key role in the ongoing management of many different types of plan investment options and retirement income products, improving transaction efficiencies, reducing transaction costs and providing tools to hedge portfolio risks.

For example, in fixed income portfolios, over-the-counter transaction costs for some securities can be substantial, especially during times of market stress or periods of low liquidity. Using interest rate swaps, rather than buying and selling these securities, allows the portfolio to remain invested without incurring unnecessary transaction costs. While futures can achieve a similar result, swaps may be more cost effective or provide a more precise implementation tool.

Swaps also may be used prudently to efficiently hedge portfolio positions, aiming to reduce risk when transactions may be either not possible or prohibitively expensive using securities. For example, during recent market turmoil, holders of commercial mortgage backed securities saw liquidity in these markets substantially reduced. At the time it was either impractical to sell these securities (dealers were unwilling to provide bids for bonds) or very expensive (bid-offer spreads of four points or more versus normal transaction costs). By using swaps, investment managers were able to protect portfolios and provide needed liquidity.

Adverse Impact of Senate Bill on 401(k) Plans

First, we believe that the definition of a “swap” contained in the bills could have the unintended consequence of materially and adversely impacting stable value funds. Existing language in the bill could be interpreted to define “swaps” to include synthetic guaranteed investment contracts, sometimes referred to as “synthetic GICs,” and other types of stable value investment contracts. DCIIA believes the impact of including stable value investment contracts in the provisions of the bill regulating “swaps” may reduce millions of 401(k) plan participants’ access to or, at minimum increase the cost of, stable value funds. We also believe it is possible that this legislation may lead to the complete elimination of stable value funds in DC plans, impacting the millions of Americans at or near retirement who rely the return and stability of stable value.

At this point, it is difficult to predict what impact these provisions will have on the viability of stable value going forward. The impact will depend largely on how different provisions of the bills are interpreted, and the many unanswered questions about the cost and feasibility of these provisions, such as the new margin and clearing provisions for swaps, especially as they would be applied to stable value. It’s important to note that this uncertainty around how the legislation may be interpreted in and of itself

has the potential to significantly and adversely impact stable value, and negatively impact the retirement security of the millions of 401(k) plan participants that currently invest in stable value.

It is a core belief of DCIIA that plan fiduciaries should have access to a wide range of investment options to help 401(k) plan participants meet their retirement goals. Like all investments, there are both pros and cons to offering stable value. While it is the intent of the new legislation to offer greater protections to investors, as written it may adversely impact Americans' retirement security by harming or possibly eliminating stable value.

Second, the bills also include fiduciary provisions intended to protect investors when a swaps dealer enters into a swap transaction with a plan. While this is a laudable goal, DCIIA's concern arises from the proposal in the Senate bill that "swap dealers" would owe a fiduciary duty to the 401(k) plan when transacting with a plan. This requirement forces the swaps dealer into a direct conflict of interest with the plan, which is directly at odds with any fiduciary standard that a swaps dealer would have to act in the best interests of the plan. Yet, the swaps dealer is really acting only as the counterparty to the plan and ERISA generally prohibits fiduciaries from representing opposing parties in a transaction. At worst, the fiduciary provisions, without amendment, would make these instruments unavailable, even when the swaps dealer provides no specific advice or recommendations to plan fiduciaries. At best, the fiduciary provisions, if enacted, could have the adverse unintended consequences of increasing costs to 401(k) plan participants and reducing investment returns. Either way, the impact on 401(k) plan participants would be negative.

Third, the bills could be interpreted to include defined contribution plans in the broad definition of "major swap participant" (or "MSP"). If included as MSPs, 401(k) plans would now have to comply with bank-style capital and margin rules, registration requirements, and sales practice rules, as well as clearing and exchange-trading mandates. The MSP provisions were designed for dealers using swaps for speculation, not entities that use swaps primarily to reduce risk. Accordingly, "end-users" of swaps that use swaps primarily to reduce commercial risk are exempted from the definition of MSP. If defined contribution plans are not also exempted from the definition of MSP, plan fiduciaries would be forced to take actions that are not consistent with how these plans operate, such as by requiring that uninvested "capital" be set aside from participant accounts. This could also hurt participant returns. On the other hand, to avoid MSP status and the associated regulatory burdens, plans may instead avoid using swaps, depriving plans of this valuable investment tool that can be used to increase efficiencies and reduce expense, volatility and risk, including in periods of market disruption.

DCIIA's Recommendations

DCIIA recommends that the bills be reconciled to preserve the benefits of the current system for stable value funds. The negative effect on stable value undercuts the proposed stability and financial reform the new legislation seeks to promote. Rather, taking steps to preserve the use of stable value by millions of Americans, many of whom are at or near retirement, provides stability for these investors and would preserve the 401(k) plan investment options already chosen by plan fiduciaries for their retirees.

Accordingly, DCIIA recommends an exception for stable value investment contracts or, if that is not practicable, the final bill should be structured so the SEC or CFTC, as applicable, is granted authority to provide an exemption for stable value investment contracts issued by bank and other regulated financial

institutions, to all or part of the swaps requirements of the bills, after undertaking a specific review of the impact of these rules on stable value and the potential for adverse consequences to the millions of 401(k) plan participants that invest in stable value.

DCIIA also recommends that swaps dealers that do not provide advice to their employee benefit plan counterparties not be considered fiduciaries to those plans, especially when the plan is represented by an established fiduciary that is not related to the swaps dealer.

Lastly, DCIIA recommends that the final bill ensure that defined contribution plans using swaps primarily to reduce portfolio risk are exempted from the definition of “major swap participant.”