ORAL STATEMENT OF
RAY GARRETT, JR., CHAIRMAN
SECURITIES AND EXCHANGE COMMISSION
TO LABOR AND IRS HEARING

January 21, 1975

Mr. Chairman:

Thank you for this opportunity to present the views of the Securities and Exchange Commission on the important exemptions which are being considered today. We have submitted a rather lengthy written statement which I understand will be included in the record of these hearings. I propose to make only a brief oral statement and then to stand ready for any questions you may have. To help me respond to your questions, I am accompanied by Gene L. Finn, Director of our Office of Economic Research, and Robert C. Lewis, Associate Director of our Division of Market Regulation.

I needn't emphasize to you gentlemen that the Securities and Exchange Commission is not vested with any authority or responsibility for the administration of the Employee Retirement Income Security Act of 1974. This authority lies in the Secretary of the Treasury and the Secretary of Labor — and we would not have it otherwise. The only reason we are presuming to intrude ourselves into questions arising under that Act is our familiarity with and concern for the operation of our capital markets, especially during this period when the process of capital formation is

uncommonly difficult, and at the same time, uncommonly important to our economic welfare.

We believe that the immediate application of those provisions of the Act with which we are concerned today will have a serious and unintended adverse effect on that process. We also believe that it will have similarly adverse effects on employee benefit plans, which are primarily your concern, and on the securities industry, which is ours.

Accordingly, we strongly support the interim exemptive relief that you propose, in order to provide time for both administrative and legislative consideration of what long-range provisions might seem appropriate. For this purpose your proposal is adequate and appropriate, and we will not indulge any temptation to improve upon it. That sort of thing can come later, here or in the Congress, since we understand that Senator Williams intends to propose legislation relating to this matter.

To state the matter as succinctly as possible, it now appears that the Act in its present form, in a commendable effort to protect employee benefit plans from abuse in the investment of their portfolios, has unintentionally created severe doubts and confusion which, until resolved, will disrupt both our capital markets and the administration of portfolios of plans. The difficulty lies in the broad reach of the definitions of party in interest and fiduciary as they relate to the ways in which securities are distributed and traded.

I should emphasize that some of the interpretations of the Act that are causing the difficulty are not inevitable. Other interpretations are plausible and possibly even intended, and in taking the more inhibiting interpretations seriously we do not mean to imply that we accept them as ultimately correct as a matter of law. At this juncture, uncertainty itself is sufficiently disruptive and a proper reason to defer application of the Act. The possibility of illegality is quite enough to cause conscientious broker-dealers in dealing with plans, and fiduciaries in managing plans, to forego otherwise beneficial transactions.

As you know, broker-dealers provide a variety of services for employee benefit plans that may cause them to become parties in interest or even fiduciaries with respect to the plans, even though they have no contractual arrangement for managing the investments of the plans and no authority or responsibility therefor. With respect to broker-dealers who are only parties in interest the continued furnishing of services, but not, apparently, trading as principal, is grandfathered until 1977 by Section 414(c)(4) of the Act. The nub of the problem lies in two possibilities. The providing of services to a plan causes the broker-dealer to become a party in interest for some indefinite period during which principal transactions with the plan are prohibited. Furthermore, the providing of some services, specifically investment advice for compensation, may cause the broker-dealer to become a fiduciary. This status likewise prohibits principal transactions and raises other problems.

We cannot be certain that this last construction of Section 3(21) is correct, but broker-dealers who are active in seeking the business of institution investors like employee benefit plans regularly supply them or their trustees or investment managers with investment advice — "research", it is commonly called — which may or may not be used. To the extent that it is regarded as valuable, the broker-dealer expects to be, and customarily is, rewarded with brokerage business by the plan. If this is "other compensation, direct or indirect", within the meaning of Section 3(21) (A) of the Act, the broker-dealer has become a fiduciary. This is not certain, but it is possible. If he becomes a fiduciary, how long that status clings to him is another uncertainty.

It seems likely that even performing brokerage services constitutes a broker-dealer a party in interest, but again we do not know for how long.

Either status is enough to prohibit principal transactions with the plan, and this is where the disruption arises. A broker-dealer may effect a securities transaction for a plan either as agent for the plan, in which case he is properly a "broker", or as principal, buying from or selling to the plan, in which case he is properly a "dealer". Sometimes this distinction may be meaningful in terms of the possibility of abuse, but often it is incidental. Some of our secondary markets of great significance to plans are conducted entirely, or almost so, on a principal basis. But even in the government or municipal bond markets, which are entirely principal or dealer markets, we assume that buying from or selling to a plan is not a "service" within the

meaning of Section 414(c) (4) and hence is not grandfathered. If the broker-dealer has become a fiduciary because of furnishing investment advice or otherwise, his services are apparently not grandfathered anyway.

Some of these matters will, I am sure, be more fully discussed by other witnesses. But the substance of it is this. Major broker-dealers supply services of one kind or another to as many plans as possible. Add to this the problem of how long the status of party in interest or fiduciary persists and you can readily see that plan managers will be severely impeded in executing a principal transaction with any of the obvious firms with which they can deal. The best market makers, or block positioners, or the broker-dealer with the best offer for a block of securities desired by a plan may be one with which the plan cannot deal, or does not dare to, because of previous brokerage or other services rendered — yesterday, last month, last year — that is one of the puzzles — or investment advice received which has been or may be compensated in soft dollars.

This wouldn't be much of a problem from the plan side if a given plan did business with only one or a few broker-dealers during a period. The fact is that most plans regularly do business with many broker-dealers. Trust departments of larger banks managing plans may do business with 100 or more broker-dealers in a year, and since institutional trading, at least in orders of any size, is relatively specialized, a plan manager could find himself unable to deal with anyone capable of handling his transaction at all, or at least on a favorable basis.

This problem is bad enough in the secondary, or trading, markets. It may well be worse with respect to the underwritten public distribution of securities, where the managing underwriters and all of the major if not all the syndicate members are parties in interest to a given plan. Raising new capital is difficult enough today without that kind of impediment, and the plans may be-denied new investment on the most favorable terms.

Finally, a word about the dimensions of what we are discussing. Private, non-insured pension funds are the second largest category of institutional investors, second only to personal trust funds. At the end of 1973, they held some $90 billion in stocks. To provide some proportion. The total market value of all stock listed on the New York Stock Exchange on December 31, 1973, was about $721 billion. Funds also held about $30 billion in corporate debt securities and $4 billion in U. S. Government and federal agency obligations. In 1973, combined stock purchases and sales by pension funds amounted to about $35 billion, more than any other institutional group for which we receive information. Total sales on the New York Stock Exchange in 1973 was about $146 billion. For the first nine months of 1974, purchases and sales of stock by private, non-insured pension funds aggregated $16.6 billion, as compared to a combined total of $23.7 billion for all mutual funds and insurance companies.

We do not have precise information relating to covered plans under the Act, but the order of magnitude is clear. Employee benefit plans constitute a

major segment of our capital markets both in terms of holdings, trading volume, and purchase of new issues, and, unlike some others, plans are growing. We believe it very important that we avoid a sudden disruption of this segment and permit time for an orderly resolution of the problems presented.