

March 2011

# 401(K) PLANS

## Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood

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Official Public Release.**



**G A O**

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Highlights of [GAO-11-291](#), a report to the Chairman, Special Committee on Aging, U.S. Senate

## Why GAO Did This Study

401(k) plan sponsors are responsible for offering an array of appropriate investment options, and participants are responsible for directing their investments among those options. While participants expect to be able to switch investment options or withdraw money from their accounts, during the recent economic downturn, some 401(k) plan sponsors and participants found that they were restricted from doing so.

GAO was asked to (1) identify some of the specific investments and practices that prevented plan sponsors and participants from accessing their 401(k) plan assets and (2) determine any changes the Department of Labor (Labor) could make to assist sponsors in understanding the challenges posed by the investments and practices that restricted withdrawals. To do this, GAO reviewed relevant federal laws and regulations and consulted with experts, federal officials, service providers, and plan sponsors.

## What GAO Recommends

GAO recommends Labor study stable value funds and the practice of securities lending with cash collateral reinvestment by 401(k) plans to identify situations or conditions where plan sponsors could be prevented from meeting their fiduciary obligations, revise one of its prohibited transaction exemptions, and provide better disclosures and guidance to plan sponsors and participants. Labor disagreed with three of GAO's recommendations and stated that it will consider the remaining four. GAO continues to believe in its recommendations.

View [GAO-11-291](#) or key components. For more information, contact Charles Jeszeck at (202) 512-7215 or [jeszeck@gao.gov](mailto:jeszeck@gao.gov).

March 2011

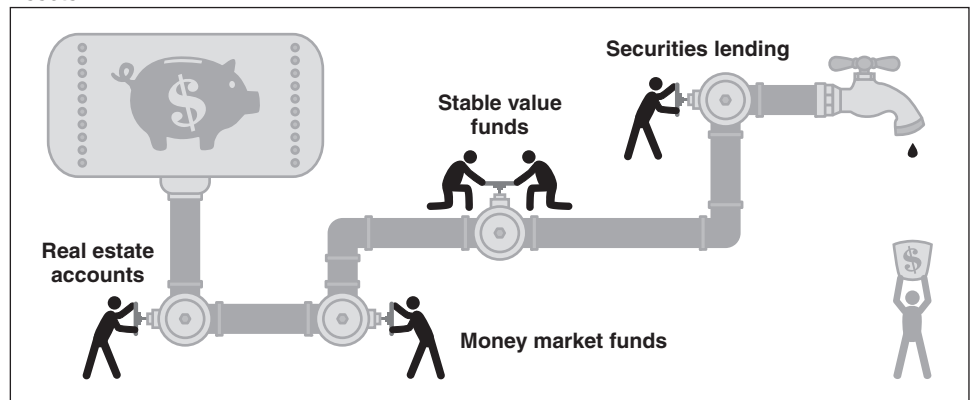
## 401(K) PLANS

### Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood

## What GAO Found

Between 2007 and 2010, some 401(k) plan sponsors and participants were restricted from withdrawing their plan assets from certain 401(k) investment options, see figure, including real estate, money market, and stable value investment options, as well as other investment options that lent securities (the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests). In most cases, the withdrawal restrictions were caused by losses and illiquidity in the investment options' underlying portfolios and sometimes contract constraints placed on plan sponsors by the investment options. For stable value funds, and also for those investment options that lent securities, the withdrawal restrictions and their causes highlight the risks that participants face when allocating their 401(k) plan assets to these investment options—and, that losses are borne by plan participants. In addition, participants often do not understand or may receive insufficient disclosures of the risks posed by these investments. Further, plan sponsors may be unaware or receive insufficient disclosures of the risks and challenges involved with those investment options and practices.

**Investments and Practices that Restricted Plan Sponsor and Participant Access to 401(k) Plan Assets**



Source: GAO.

Labor can take a variety of steps to help plan sponsors who offer stable value funds and investment options that lend securities. Many of these steps can draw upon the changes that the Securities and Exchange Commission and others have already made, or will make, regarding these investment options and recent suggestions from plan sponsors, industry service providers, and other key stakeholders. Specifically, Labor could identify and take action to address those stable value contract constraints that may hinder plan sponsors from performing their fiduciary responsibilities and provide better disclosures to plan sponsors about certain investment options to help sponsors make decisions on behalf of participants. Similarly, revising Labor's prohibited transaction exemption for securities lending to restrict those securities lending arrangements that may pose unreasonable financial terms upon plans and providing more guidance, in general, about such transactions can also help plan sponsors and participants understand the risks that cash collateral reinvestment can pose to plan assets in investment options that lend securities and how to mitigate them.

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### Abbreviations

CFTC	Commodity Futures Trading Commission
CIF	collective investment fund
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Industry Regulatory Authority
FRB	Federal Reserve Board
GIC	guaranteed investment contract
OCC	Office of the Comptroller of the Currency
PTE	prohibited transaction exemption
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission

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United States Government Accountability Office  
Washington, DC 20548

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March 10, 2011

The Honorable Herb Kohl  
Chairman  
Special Committee on Aging  
United States Senate

Dear Mr. Chairman:

The recent problems in the U.S. mortgage market and subsequent financial crisis revealed underlying weaknesses in the U.S. financial system and illustrated the importance of due diligence in financial matters. Investors, including 401(k) plan participants, experienced large losses from their investments in 2008.<sup>1</sup> There were reports that some 401(k) participants experienced losses and were restricted from accessing their plan assets in certain situations, and that employers that sponsored 401(k) plans (plan sponsors) were also restricted from withdrawing plan assets. Nearly 90 percent of all 401(k) plans are participant-directed, meaning they generally allow participants to choose how much to invest, within federal limits, and to select from a menu of diversified investment options chosen by the plan sponsor. As such, most 401(k) plan participants expect to be able to switch investment options or withdraw money from their accounts.<sup>2</sup> Similarly, plan sponsors also expect to be able to change the investment options offered to their 401(k) plan participants without significant restrictions and, in fact, have a duty under the Employee Retirement Income Security Act of 1974 (ERISA) to act prudently when selecting investment options for plan participants and to act solely in the interest of the participants. The financial crisis illustrated that withdrawal restrictions can be a condition of certain investments, but they can also be

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<sup>1</sup>Industry researchers have estimated that the average 401(k) retirement account balance declined 27.8 percent in 2008, before rising 31.9 percent in 2009. Thus, over this 2-year period, the average retirement account balance lost 4.8 percent. For example, if the average 401(k) retirement account balance was \$100, a decline of 27.8 percent would bring the balance to \$72.20 at the end of 2008. Then, an increase of 31.9 percent would bring the balance to \$95.20 at the end of 2009. According to an industry association, the average 401(k) retirement account balance outperformed the S&P 500 Index in both 2008 and 2009.

<sup>2</sup>Other 401(k) plans are trustee-directed, wherein an employer appoints trustees who decide how the plan's assets will be invested. For the purposes of this report, we are discussing participant-directed 401(k) plans.

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a limitation of which some plan participants and plan sponsors may not be aware.

Since it was unclear from the reports why certain types of investment options restricted withdrawals and how and when withdrawal restrictions were placed, we were asked to determine what happened during the financial crisis to participant accounts and to plan sponsors' control over the investment options offered to 401(k) plan participants. To better understand the type of investments that were offered to plan participants and whether plan participants and plan sponsors were adequately informed about the potential for withdrawal restrictions, we answered the following questions:

1. What are some of the specific investments and practices that prevented plan sponsors and participants from accessing 401(k) plan assets?
2. What changes, if any, could Labor make to assist plan sponsors in understanding the challenges posed by certain investments and practices?

To determine the specific practices that may have affected plan sponsors' and participants' access to 401(k) plan assets during the recent market downturn, we reviewed articles published by industry experts, related documents from the Department of Labor (Labor), such as published materials available to plan fiduciaries regarding plan investment practices or suggested disclosures, and a report by Labor's ERISA Advisory Council. We also conducted a short poll of plan sponsors. The poll was conducted in coordination with *Plansponsor Magazine (Plansponsor)* and asked plan sponsors about withdrawal restrictions in their plans. The poll respondents were members of *Plansponsor's* subscription list, and their responses cannot be considered representative of the overall population of 401(k) plan sponsors. Our main use of this information was to better inform our understanding of these issues from a plan sponsor perspective and to design our subsequent audit work. Because of the methodological limitations and low response rate of this poll, this information is anecdotal and represents only the views of the 74 members who responded to our poll.

To demonstrate the scope of the potential effects of withdrawal restrictions and risks to participants' earnings, we gathered data from industry associations and private researchers; however, because there was no comprehensive data source available, it was difficult to determine how

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widespread the incidences of withdrawal restrictions were and to quantify any losses to 401(k) participant accounts. We also interviewed plan sponsors, plan service providers, representatives from industry associations, researchers, and Labor officials to determine the circumstances that led to withdrawal restrictions during the recent market downturn, to get an understanding of the advantages and disadvantages of investing in certain investment options and engaging in certain investment practices, and to determine the various relationships between 401(k) plans and parties involved in these investment options and practices.

To examine how the oversight and regulatory requirements governing withdrawal restrictions ensure that 401(k) plan sponsors and participants are aware of the potential for restricted access to plan investment options, we reviewed ERISA and Labor's related regulations, guidance, and frequently asked questions to determine their specific disclosure requirements and fiduciary responsibility standards. We reviewed the relevant federal laws and regulations, including those pertaining to disclosure requirements, of the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC), and interviewed officials at each of the federal entities about how they govern withdrawal restrictions and other investment practices. We reviewed Labor's, SEC's, and banking regulators', requirements to see if changes to those requirements could better inform plan sponsors and participants of the risks associated with certain investments and investment practices. We also collected and reviewed examples of disclosures from various investment options offered by 401(k) plans to see if the disclosures were clear and understandable and if they complied with current requirements. In addition, we interviewed Labor officials about how they oversee withdrawal restrictions and monitor disclosures to plan sponsors and participants, and interviewed service providers, other industry and participant organizations, and pension professionals to obtain their views on current oversight, disclosure and fiduciary requirements.

We conducted this performance audit from November 2009 to March 2011, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

Under Title I of ERISA, plan sponsors are permitted to offer their employees two broad types of retirement plans, defined benefit and defined contribution. Plan sponsors that offer defined benefit plans typically invest their own money in the plan and, regardless of how the plans' investments perform, promise to provide eligible employees guaranteed retirement benefits, which are generally fixed levels of monthly retirement income based on years of service, age at retirement, and, frequently, earnings. In contrast, plan sponsors that offer defined contribution plans do not promise employees a specific benefit amount at retirement—instead, the employee and/or their plan sponsor contribute money to an individual account held in trust for the employee. The employee's retirement income from the defined contribution plan is based on the value of their individual account at retirement, which reflects the contributions to, performance of the investments in, and any fees charged against their account. Over the past three decades, there has been a general shift by plan sponsors away from defined benefit plans to defined contribution plans.

The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pretax compensation to the plan under section 401(k) of the Internal Revenue Code.<sup>3</sup> The use of 401(k) plans accelerated in the 1980s after the U.S. Department of the Treasury (Treasury) issued a ruling clarifying a new section of the tax code that allowed employers and employees to make pretax contributions, up to certain limits, to employees' individual accounts. According to estimates by industry researchers, 49 million Americans were active 401(k) plan participants in 2009 and, by year end, 401(k) plan assets amounted to \$2.8 trillion.<sup>4</sup> In most 401(k) plans, participants bear the risk of their investments' performance and the responsibility for ensuring they have adequate savings in retirement. Participants may, under certain circumstances, withdraw their retirement savings early but may have to pay tax penalties for doing so. Current law limits participant access to retirement savings in employer-sponsored retirement plans although, in certain circumstances, 401(k) plan sponsors

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<sup>3</sup>In 2010, the federal limit for pretax contributions to 401(k) accounts was \$16,500. Participants aged 50 and over were eligible for an additional \$5,500 in "catch-up" contributions.

<sup>4</sup>Employee Benefit Research Institute. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009*, Issue Brief No. 350 (Washington D.C.: November 2010).



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may provide participants with access to their tax-deferred retirement savings before retirement.<sup>5</sup>

Plan sponsors that offer 401(k) plans have responsibilities under ERISA. The law establishes that a plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets.<sup>6</sup> Typically, the plan sponsor is a fiduciary under this definition. ERISA requires that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries. In accordance with ERISA and related Labor regulations and guidance, plan sponsors and other fiduciaries must exercise an appropriate level of care and diligence given the scope of the plan and act for the exclusive benefit of plan participants and beneficiaries, rather than for their own or another party's gain. Responsibilities of a fiduciary may include, but are not limited to

- selecting and monitoring any service providers to the plan;
- reporting plan information to the federal government and to participants;
- adhering to the plan documents, including any investment policy statement;
- identifying parties-in-interest to the plan and taking steps to monitor transactions with them;
- selecting and monitoring investment options the plan will offer and diversifying plan investments; and
- ensuring that the services provided to the plan are necessary and that the cost of those services is reasonable.

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<sup>5</sup>Plan sponsors may provide participants access to their retirement savings in the form of a participant loan, a hardship withdrawal, or a lump-sum distribution when the participant separates from the plan sponsor. Participants who take an early distribution generally pay a 10 percent early withdrawal penalty and income taxes on the distribution amount and may face other restrictions and fees, such as loan origination fees.

<sup>6</sup>Labor's proposed regulations of October 2010, would amend the definition of an ERISA fiduciary, reducing the number of conditions that need to be met to be deemed an ERISA fiduciary. As such, the proposed regulation, if finalized, would encompass a greater number of entities assisting plan sponsors with selecting investment options. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

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Because 401(k) plans place the responsibility for ensuring adequate retirement savings on participants and limit a fiduciary's liability for investment decisions made by participants, Labor has placed additional responsibilities on plan sponsors and their fiduciaries who offer these plans. For participants to have control, they must be given the opportunity to choose from a broad range of investment alternatives. They must be allowed to give investment instructions at least once a quarter and perhaps more often if the investment option is volatile. In addition, participants must be given sufficient information to make informed decisions about the investment options offered under the plan.<sup>7</sup>

ERISA allows plan sponsors to hire companies that will provide the services necessary to operate their 401(k) plans. Service providers are various outside entities, such as investment companies, banks, or insurance companies that a plan sponsor hires to provide the services necessary to operate the plan such as

- investment management (e.g., selecting and managing the securities included in a mutual fund);
- consulting and providing financial advice (e.g., selecting vendors for investment options or other services);
- record keeping (e.g., tracking individual account contributions);
- custodial or trustee services for plan assets (e.g., holding the plan assets in a bank); and
- telephone or Web-based customer services for participants.

Labor's Employee Benefits Security Administration (EBSA) oversees 401(k) plans,<sup>8</sup> educates and assists plan sponsors and participants,

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<sup>7</sup>Our recent reports on target date funds and conflicted investment advice illustrate that managing the risks faced in saving for retirement through 401(k) plans today can be complicated and pose significant challenges for participants and sponsors alike. See GAO, *Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*, [GAO-11-118](#) (Washington, D.C.: Jan. 31, 2011); and GAO, *401(k) Plans: Improved Regulation Could Better Protect Participants from Conflicts of Interest*, [GAO-11-119](#) (Washington, D.C.: Jan. 28, 2011).

<sup>8</sup>IRS also oversees various aspects of 401(k) contributions under the Internal Revenue Code.

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investigates alleged violations of ERISA, responds to requests for interpretations of ERISA through advisory opinions and rulings, and makes determinations to exempt transactions that would otherwise be prohibited under ERISA.<sup>9</sup> However, the specific investment products commonly offered in 401(k) plans fall under the authority of the applicable securities, banking, or insurance regulators. These regulators include SEC, federal and state banking agencies, and state insurance commissioners as follows:

- SEC, among other responsibilities, regulates securities markets and issuers, including mutual funds under various securities laws.
- Federal agencies charged with oversight of banks—primarily FRB, OCC, FDIC, and state banking agencies—oversee bank investment products, such as collective investment funds (CIF),<sup>10</sup> which are trusts that pool the investments of retirement plans or other institutional investors.<sup>11</sup>
- State insurance agencies generally regulate insurance products. Some investment products may also include one or more insurance elements, which are not present in other investment options. Generally, these elements include an annuity feature and interest and expense guarantees.<sup>12</sup>

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<sup>9</sup>Labor regulations specify that participants must be offered at least three different investment options so that they can diversify investments within an investment category, such as through a mutual fund, and diversify among the investment alternatives offered.

<sup>10</sup>The operation of CIFs by national banks is subject to regulation under OCC regulations. While certain CIFs offered by state banks must comply with OCC regulations in order to qualify for tax-exempt treatment (*See* 26 U.S.C. § 584) these CIFs generally are not limited to employee benefit assets. CIFs offered by state banks that consist solely of employee benefit assets such as retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income tax must only comply with applicable state law requirements (which may include a cross-reference to OCC regulations) and are not required under the tax code to comply with OCC regulations. 12 C.F.R. § 9.18(a)(2).

<sup>11</sup>An institutional investor is an organization that pools large sums of money and invests those sums in securities, real property and other investment assets. Institutional investors include banks, insurance companies, retirement or pension funds, hedge funds, foundations and mutual funds.

<sup>12</sup>In the United States, an annuity contract is created when an insured party, usually an individual, gives an insurance company money that will later be distributed back to the insured party over time. Annuity contracts traditionally provide a guaranteed distribution of income over time, until the death of the person or persons named in the contract or until a final date, whichever comes first.

**401(k) Investment Options** ERISA does not prohibit a plan from offering any type of investment to its participants, but gives plan sponsors flexibility to choose the investments to be offered through their 401(k) plans.<sup>13</sup> There are many types of 401(k) investment options, including those listed in table 1.

**Table 1: Investment Options Typically Offered through a 401(k) Plan**

Type of investment option	Description
Real estate accounts	Real estate accounts are open-ended, commingled accounts that invest directly in real estate, such as funds that buy and manage commercial properties. Real estate accounts are equity accounts consisting primarily of high quality, well-leased real estate properties in the industrial, office, retail, and hotel sectors. If real estate accounts are offered by insurance companies as separate accounts, they are regulated by the State Insurance Commissioner in the state they are created.
Mutual funds	A mutual fund, legally known as an open-end investment company, is a company that pools money from many investors and invests the money in stocks, bonds, short-term money market instruments, other securities or assets, or some combination of these investments. These investments comprise the fund's portfolio. Mutual funds are registered and regulated under the Investment Company Act of 1940, and are supervised by the SEC. Mutual funds sell shares to public investors. Each share represents an investor's proportionate ownership in the fund's holdings and the income those holdings generate. Mutual fund shares are "redeemable," which means that when mutual fund investors want to sell their shares, the investors sell them back to the fund, or to a broker acting for the fund, at their current net asset value per share, minus any fees the fund may charge.
Money market funds	Money market funds are open-end management investment companies that are registered under the Investment Company Act of 1940, and regulated under rule 2a-7 under that act. Money market funds invest in high-quality, short-term debt instruments such as commercial paper, treasury bills and repurchase agreements. Generally, these funds, unlike other investment companies, seek to maintain a stable net asset value per share (market value of assets minus liabilities divided by number of shares outstanding), typically \$1 per share.
Collective Investment Funds (CIFs)	A CIF is a bank-administered trust that holds commingled assets that meet specific criteria. Each CIF is established under a "plan" that details the terms under which the bank manages and administers the fund's assets. The bank acts as a fiduciary for the CIF and holds legal title to the fund's assets. Participants in a CIF are the beneficial owners of the fund's assets. While each participant owns an undivided interest in the aggregate assets of a CIF, a participant does not directly own any specific asset held by a CIF. CIFs are designed to enhance investment management by combining assets from different accounts into a single fund with a specific investment strategy. Many banks establish CIFs as an investment vehicle for employee benefit accounts, including 401(k) plans.

<sup>13</sup>Title I of ERISA does not proscribe or prohibit particular types of investment products or options, but plan sponsors must conduct due diligence and prudently select the investment options they want to offer to their participants.

Type of investment option	Description
Balanced funds	Balanced funds are pooled accounts invested in stocks, bonds, and often additional asset classes. They are classified into two subcategories: target-date funds and nontarget-date balanced funds. Target date funds are often registered mutual funds and hold a mix of stocks, bonds, and other investments. Over time, the investment allocation gradually shifts according to the fund's investment strategy. Target date funds are designed to be investments for individuals with particular retirement dates in mind. The name of the fund often refers to its target date. For example, a fund with the name "Target 2030" is designed for individuals who intend to retire in or near the year 2030. Nontarget-date balanced funds include asset allocation or hybrid funds.
Stable value funds	Stable value funds are a fixed income investment option, designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns set in the contract. See below for more information.

Source: GAO.

Note: See [GAO-11-118](#) for more information on target date funds.

Labor reports that, in recent years, there has been a dramatic increase in the number of investment options typically offered under 401(k) plans. Many investments offered under 401(k) plans today pool the money of a large number of individual investors into funds called commingled or pooled accounts.<sup>14</sup> However, larger plans are more likely to structure their investments in separate accounts.<sup>15</sup> Both types of accounts may be invested in stocks, bonds, or real estate, but the type and number of options plan sponsors offer to participants in any given 401(k) plan vary based on a number of factors, including the size of the plan and the chosen plan service providers.

Results from a 2009 survey conducted by an industry consulting firm show that the most commonly offered 401(k) investment options in 2009 were equity, bond, and stable value funds.<sup>16</sup> Results from the survey also indicated that the percentage of plans offering money market funds significantly increased between 2007 and 2009. As shown in figure 1, equity funds accounted for over 40 percent of the 401(k) plan assets at the close of 2009. Other plan assets were invested in company stock; stable value funds, including guaranteed investment contracts; balanced funds; bond funds; and money funds.

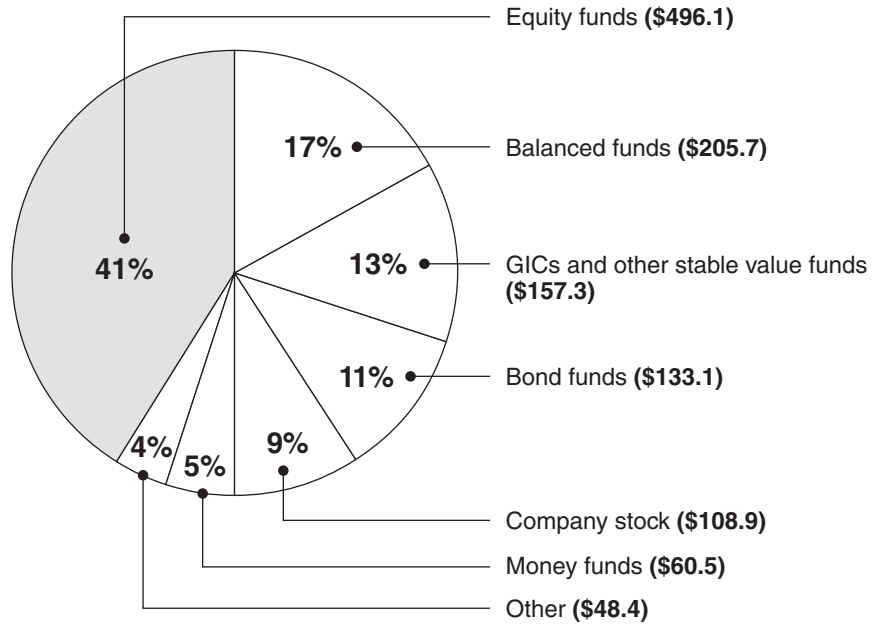
<sup>14</sup>Commingled or collective funds are designed to combine the assets of unrelated retirement plans, enabling participants to diversify and gain the economies of scale, i.e., the advantages that being part of a larger fund affords, such as greater profits and less cost. Participants own a share in a pool of assets.

<sup>15</sup>For plans that offer separate accounts, participants own the assets in the pool.

<sup>16</sup>Hewitt Associates, *Trends and Experience in 401(k) Plans* (Lincolnshire, IL: 2009).

**Figure 1: Estimated Aggregate Asset Allocation of 401(k) Plan Assets, 2009**

Dollars in billions



Sources: Employee Benefit Research Institute and Investment Company Institute.

Note: GAO analyzed data provided in the November 2010 EBRI Issue Brief No. 350, in which EBRI and ICI summarize data from their 2009 EBRI/ICI 401(k) database. According to EBRI and ICI, at year end 2009, all 401(k) plans held a total of \$2.8 trillion in assets, and that the database is a representative sample of the estimated universe of 401(k) plans. EBRI and ICI state the database contains information on over 51,000 401(k) plans (about 10 percent of plans) with \$1.21 trillion in assets (about 44 percent of 401(k) plan assets) and about 20 million participants (about 42 percent of the universe of active 401(k) plan participants). The percentages presented in this figure are estimates of 401(k) plan assets included in each investment type based on the population covered in the database, or \$1.21 trillion in 401(k) plan assets. The “Equity funds” and “Bond funds” categories consist of pooled investments—including mutual funds and CIFs—that are primarily invested in stocks and bonds, respectively. The “Other” category is the residual for other investments, such as real estate funds, and the “Money funds” category includes money market funds and other funds that are designed to maintain a stable share price, other than GICs and stable value funds. For definitions of key terms used in the report, please see the glossary.

## Stable Value Funds

A key type of investment commonly offered through 401(k) plans is the stable value fund, which is a capital preservation investment option. These funds are primarily offered to defined contribution plan participants,

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including 401(k) plan participants.<sup>17</sup> Stable value funds are marketed as being invested in high-quality, diversified fixed income investments that are protected against interest rate volatility. According to the Stable Value Investment Association, about 50 percent of 401(k) plans offer stable value funds and when a stable value fund is offered, participants put about 15 to 20 percent of their plan assets, on average, into the investment option. Stable value funds are designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns.

While these funds attempt to maintain a stable return, actual return could vary over time because of changes in the market value of the underlying stable value portfolio assets, among other things.<sup>18</sup> To protect the fund from interest rate volatility, an important component of a stable value fund is the contract that plan sponsors or stable value fund managers purchase from plan service providers, including banks and insurers. The contract is a guarantee by a service provider, in the event of participant withdrawals, to pay participants at book value should the market value of the stable value portfolio be worth less than the amount needed to pay that book value.<sup>19</sup> As part of the price of providing this guarantee, contract providers

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<sup>17</sup>The stable value fund industry used to offer "stable value mutual funds" to investors who invested in Individual Retirement Accounts; however, after SEC staff raised concerns about the funds' accounting methods, stable value mutual funds were terminated.

<sup>18</sup>The market value of a stable value fund is the collective prices at which the underlying assets of the fund are trading in the market at a given time.

<sup>19</sup>The book value of a stable value fund is the principal contributed to the investment option, plus accrued interest, minus withdrawals and fees. Accrued interest, minus withdrawals and fees, is calculated based on a methodology specified in the stable value fund contract and is reset on a periodic basis, which is usually quarterly or semiannually.

typically require certain restrictions on plan sponsor and participant withdrawals or transfers of plan assets from stable value funds.<sup>20</sup>

While the market value of a stable value fund fluctuates as market prices of the underlying assets rise and fall, its book value fluctuates much less often, if at all—the rate of return may be fixed, indexed, or reset periodically based on certain factors, including the actual performance of the underlying assets—depending on the type of stable value fund contract obtained by the plan. Table 2 describes the three types of stable value fund contracts. Stable value funds may hold one contract type or a combination of contracts.

**Table 2: Descriptions of the Three Types of Stable Value Fund Contracts**

Type of stable value fund	Description
Traditional guaranteed investment contracts (GIC)	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return regardless of the performance of the underlying assets, which the insurance company owns and holds within their general account.
Separate account GICs	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return, which may be fixed, indexed, or reset periodically based on the actual performance of the underlying assets. The insurance company owns and holds the underlying assets in a separate, customized account for the exclusive benefit of a single plan.
Synthetic GICs	Plan sponsors contract with a bank or insurance company to guarantee participants principal protection and a rate of return relative to a portfolio of assets held in an external trust owned by the plan. The rate of return, which is based on the actual performance of the underlying assets, is reset periodically.

Source: GAO.

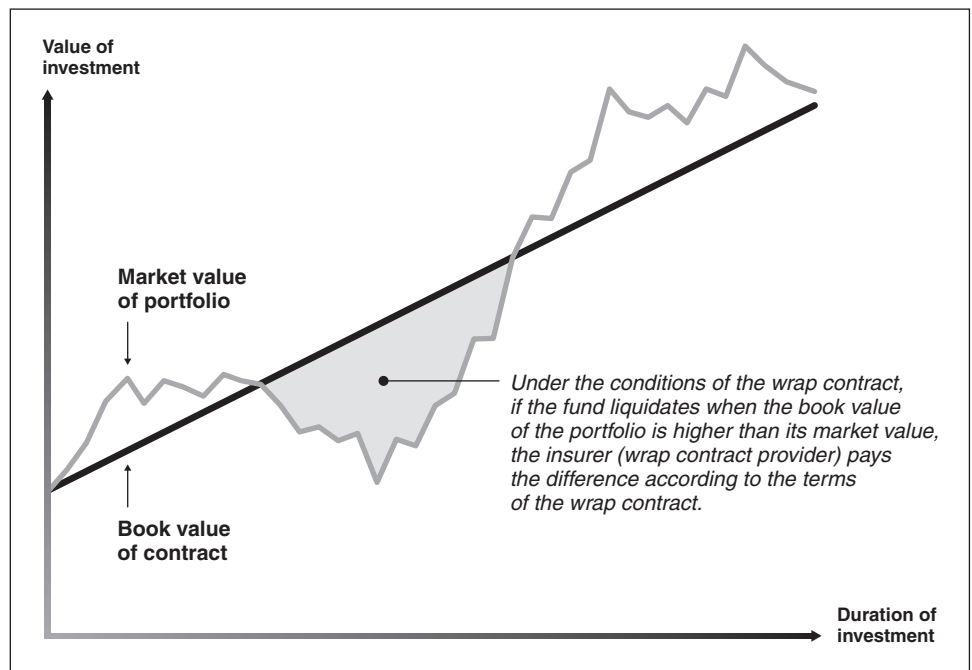
Note: For the purpose of this report, stable value funds described are those typically categorized as synthetic guaranteed investment contracts.

<sup>20</sup>In fact, according to a stable value fund provider, plan sponsor restrictions are necessary to provide the fund manager with a tool to protect the remaining investors in the fund and to protect the issuers of wrap contracts used by the funds. Similarly, in a 2006 *Akron Law Review* publication, an industry expert notes that, in order for a wrap contract to be a financially sound product, wrap contract providers nearly universally insist that plan participants not be allowed to make direct transfers from a stable value fund into a money market fund. The author argues that these participant restrictions are not only necessary to maintain favorable returns above those of other low-risk investments, but also to ensure that less financially sophisticated plan participants are not disadvantaged by financially sophisticated, market-timing plan participants. Paul J. Donahue, “Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market,” *Akron Law Review* 39, No. 1 (2005-2006).



For synthetic GICs, contracts are called “wrap contracts.” These stable value funds may obtain multiple wrap contracts from wrap contract providers to cover the underlying assets held in the stable value portfolio. As shown in figure 2, if participants want to withdraw funds when the value of a stable value portfolio falls below the book value the wrap contract provider may make up the difference for participants. In this situation, the wrap contract provider must only cover the difference between market value and book value if the total amount of participants’ withdrawals exceeded the market value of the underlying stable value portfolio.

**Figure 2: Stable Value Fund Wrap Contract**



Source: GAO presentation of Stable Value Investment Association information.

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## 401(k) Investment Practice: Securities Lending with Cash Collateral Reinvestment

Many of the investment options offered by plan sponsors, including money market funds, stable value funds, and equity funds, engage in a practice called securities lending, where some of the assets held in these investment options on behalf of plan participants are lent out for a period of time to a third party, usually a broker-dealer.<sup>21</sup> In return, the broker-dealer provides collateral to the securities lending agent to hold until the broker-dealer returns the borrowed securities.<sup>22</sup> For example, an S&P 500 index fund will hold the same stocks in approximately the same ratio as they comprise the S&P 500, in an attempt to approximate the return of the S&P 500. There will always be a gap between the S&P 500 and an index fund that tries to approximate the returns of the S&P 500, by buying and selling stocks to maintain the same values as are held in the S&P 500. This gap, also known as “tracking error,” is caused by, among other things, fund expenses, such as investment advisory fees, and brokerage expenses, that the index itself would not have. These index funds may try to decrease the gap by earning greater return on the stocks they hold by temporarily lending out the securities and then investing the cash collateral they receive.<sup>23</sup> Table 3 defines the various parties involved in a typical securities lending transaction.

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<sup>21</sup>Some of the \$2.8 trillion in assets held in 401(k) plans at the end of 2009 were utilized in securities lending programs, but the specific percentage is unknown. The percentage of assets lent out at any given time varies by type of 401(k) investment option. While SEC staff, by no-action letters, limit the percentage of assets in mutual funds and money market funds that can be utilized in securities lending programs, other 401(k) investment options that are not registered with SEC, such as some equity, bond, and stable value funds, are generally not limited in the percentage of assets that can be utilized by securities lending programs.

<sup>22</sup>The securities lending agent takes collateral for the loan that can be either cash or securities, such as bonds or stocks. However, in the United States, cash is the primary form of collateral taken in securities lending transactions and, thus, for the purpose of this report, investment options that lend securities are those investment options that participate in the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests, or securities lending with cash collateral reinvestment.

<sup>23</sup>If the investment option takes cash as collateral, the lender has the right to reinvest that cash to earn an additional return. The borrower does not pay an additional fee to borrow the securities, called a “negative rebate,” unless the security is in extremely high borrowing demand. If the investment option takes securities as collateral, the borrower will pay the lender a fee.

**Table 3: Various Parties Involved in a Typical Securities Lending Transaction with Cash Collateral Reinvestment**

Entity	Role
Plan participants	Plan participants contribute to their 401(k) and direct that contribution to certain investment options. In 401(k) plans, the assets are held in trust for participants.
Plan sponsor	A plan sponsor chooses which investment options to offer to its participants and, when making that choice, may decide whether to offer investment options that engage in securities lending.
Plan service provider	A plan service provider purchases securities on behalf of 401(k) plan participants. May act as securities lending agent. <sup>a</sup>
Securities lending agent	The securities lending agent may coordinate loans of securities, hire a manager to invest cash collateral, and often takes on counterparty risk—or the risk that the borrower will fail to return the securities—on behalf of the plan. May be an affiliate of the custodian, i.e., an entity, usually a bank, that has legal responsibility for safekeeping a plan’s securities.
Borrower	The borrower contracts with a broker-dealer to acquire the securities it needs to cover its obligations. The broker-dealer can also be the borrower. There are many reasons why an entity might seek to borrow securities, including for “short” sales, i.e., borrowing a security from a broker and selling it, with the understanding that it must be bought back and returned to the broker. Short selling is a technique used by investors who try to profit from the falling price of a stock.
Broker-dealer	The broker-dealer borrows securities on behalf of its customers, providing cash as collateral to the securities lending agent. <sup>b</sup> A broker-dealer is a company or other organization that trades securities for its own account or on behalf of its customers. Although many broker-dealers are “independent” firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer.
Cash collateral pool manager	The cash collateral pool manager invests the cash provided as collateral for the borrowed securities in order to earn additional return for the securities lending agent during the period of time that the securities are borrowed. The securities lending agent can be the cash collateral pool manager, but usually it is an affiliate of the securities lending agent.

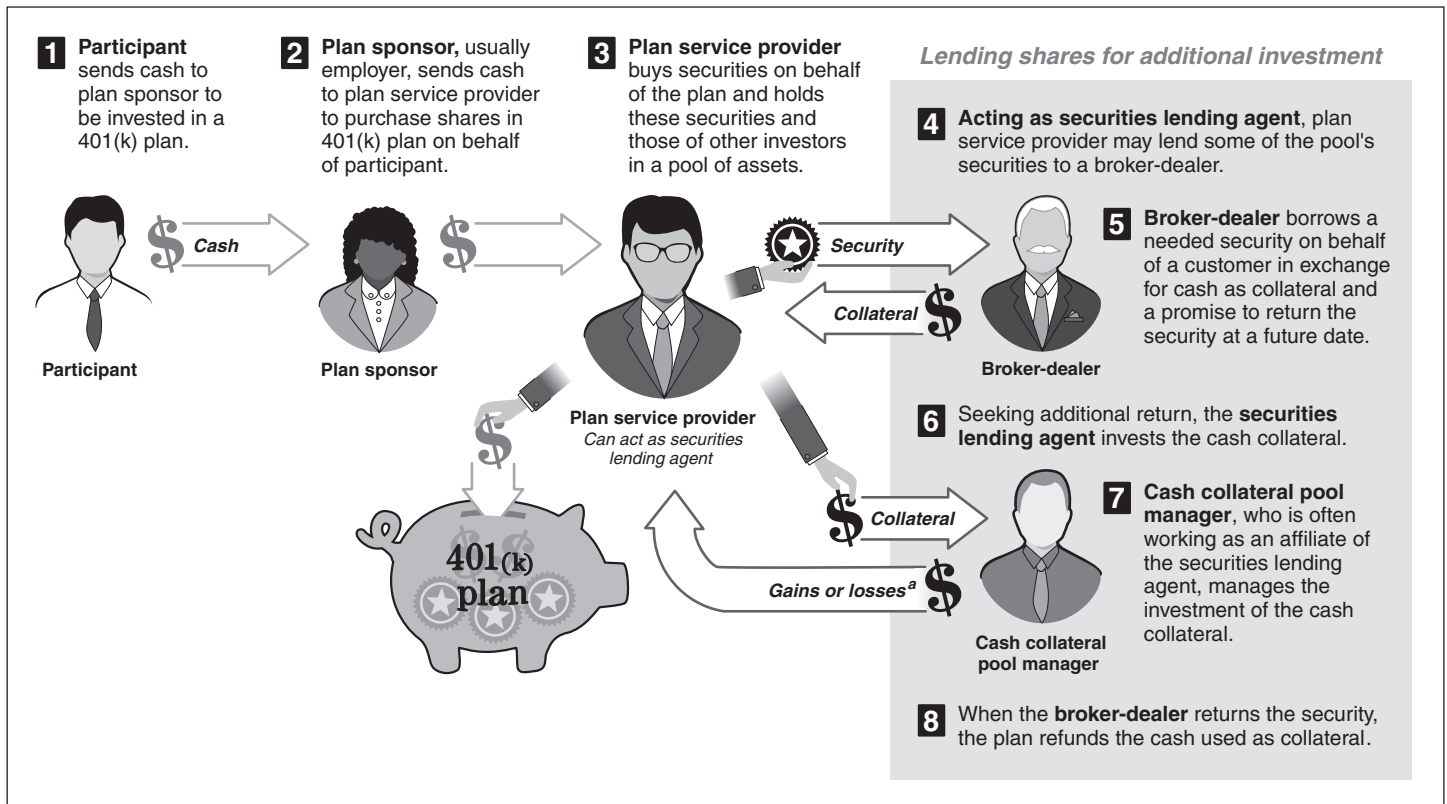
Source: GAO.

<sup>a</sup>Custodial banks commonly provide securities lending services to defined benefit and defined contribution plans. If the plan invests plan assets in separate accounts, plan sponsors can choose whether or not to participate directly in a securities lending program. If the plan invests plan assets in commingled accounts—including mutual funds and collective investment funds—it may also participate indirectly in securities lending if those commingled accounts participate in securities lending.

<sup>b</sup>The amount of collateral provided by the broker-dealer may depend on the type of security being lent. For U.S. securities a typical collateral rate is 102 percent, for international securities it is 105 percent, of the value of the securities being lent out.

Figure 3 shows how a simple securities lending transaction would work.

**Figure 3: Example of a Simple Securities Lending with Cash Collateral Reinvestment Transaction**



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

Note: When securities are on loan, the lenders, or plan participants, retain all the benefits of ownership including rights to dividends, interest payments, corporate actions (excluding proxy voting), and market exposure to unrealized capital gains or losses.

<sup>a</sup>Participants earn additional return in this transaction when the reinvested cash collateral earns more than the amounts owed to (1) the cash collateral pool manager as a fee for managing the cash collateral pool and (2) the broker-dealer as a “rebate.” Generally the return left over after these two entities are paid is split between the securities lending agent and plan participants in varying percentages. The proceeds from securities lending that plan participants receive typically serves to offset custody fees and administrative expenses or to simply enhance participants’ portfolio returns.

Institutions engaged in securities lending for a 401(k) plan subject to ERISA are supposed to take all steps necessary to design and maintain their programs to conform to an ERISA exemption that authorizes securities lending transactions that might otherwise constitute “prohibited

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transactions” under ERISA.<sup>24</sup> In general, ERISA prohibits parties-in-interest—such as service providers, plan fiduciaries, the employer, the union, owners, officers, and relatives of parties-in-interest—from doing business with the plan<sup>25</sup> but provides various exemptions to these prohibited transactions.<sup>26</sup> Some of the exemptions provide for dealings with banks, insurance companies, and other financial institutions essential to the ongoing operations of the plan. Labor issued Prohibited Transaction Exemption (PTE) 2006-16 to allow the lending of securities by employee benefit plans to certain banks and broker-dealers and to permit the payment of compensation to a lending fiduciary for services rendered in connection with loans of plan assets that are securities.<sup>27</sup>

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## Certain Investment Options Placed Withdrawal Restrictions on 401(k) Plan Sponsors and Participants

Between 2007 and 2010, some plan sponsors and participants were restricted from withdrawing their plan assets from certain 401(k) investment options, such as real estate, money market, and stable value

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<sup>24</sup>Prohibited Transaction Exemption (PTE) 2006-16; Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006).

<sup>25</sup>29 U.S.C. § 1106. Prohibited transactions under ERISA include a sale, exchange, or lease between the plan and party-in-interest; lending money or other extension of credit between the plan and party-in-interest; and furnishing goods, services, or facilities between the plan and party-in-interest, among other prohibited transactions. Labor may grant administrative exemptions from the prohibited transaction provisions of ERISA.

<sup>26</sup>ERISA provides a number of detailed exemptions to its prohibited transaction provisions and permits Labor to establish additional ones. 29 U.S.C. §1108.

<sup>27</sup>Prohibited Transaction Exemption (PTE) 2006-16. This exemption permits the lending of securities owned by an employee benefit plan to persons who would otherwise constitute a “party in interest” with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities and permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities.

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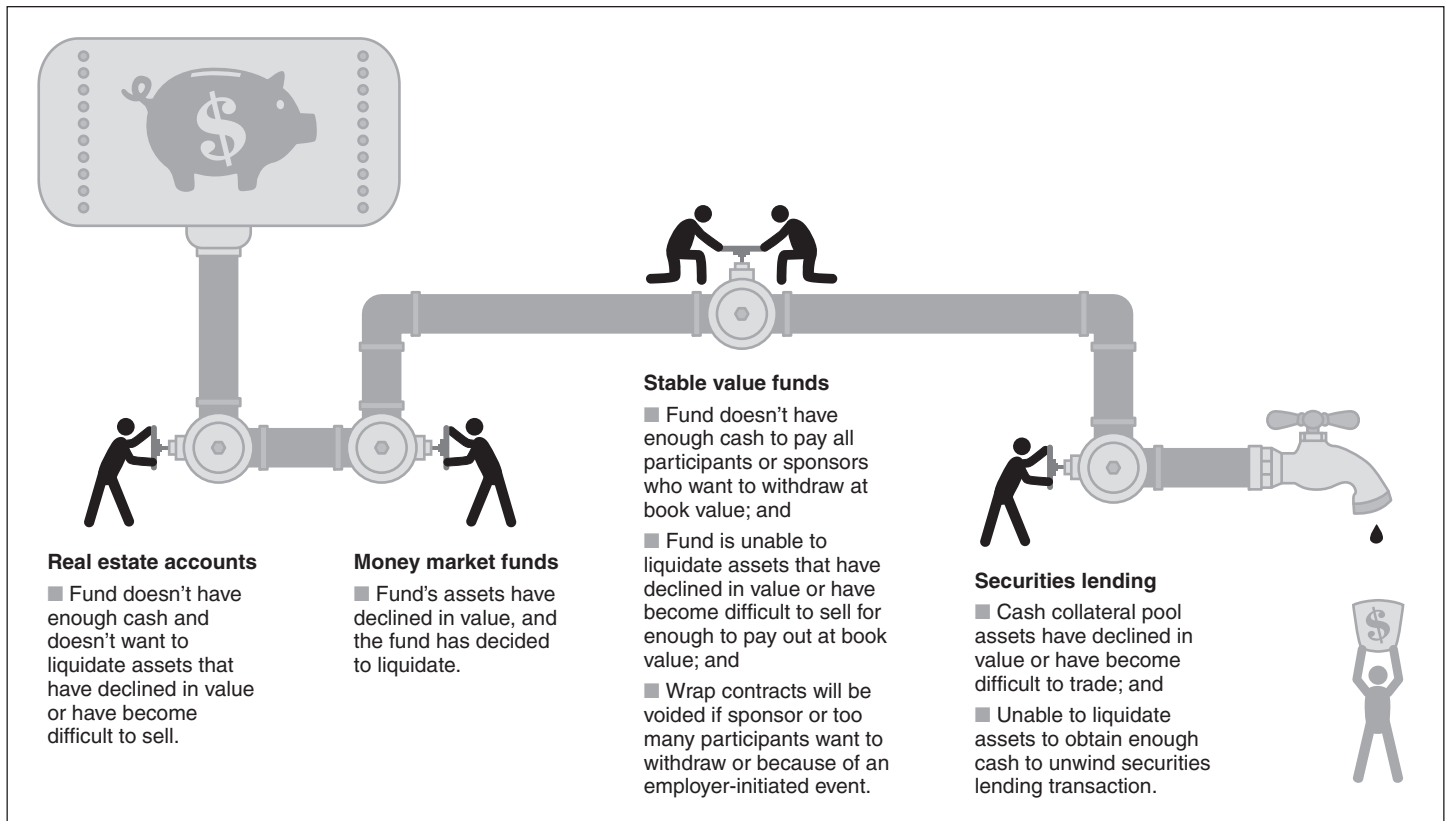
investment options.<sup>28</sup> As shown in figure 4, beyond elevated levels of withdrawal requests, there were various reasons why certain investment options restricted withdrawals.<sup>29</sup>

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<sup>28</sup>There are a number of reasons why plan sponsors and participants may want to withdraw their assets. For example, plan sponsors can switch investment options because they want to offer different investment options or because fees are too high at their current service provider. Participants often transfer their plan assets into riskier or safer investment options or may withdraw their 401(k) assets because they are experiencing a personal hardship. Participants are also allowed to withdraw their assets when they retire. Between 2007 and 2010, while some investment options placed restrictions on participants and sponsors who wanted to withdraw to move their plan assets into other investments, investment options generally did not restrict certain withdrawals that were defined by plan sponsors. This included hardship withdrawals and withdrawals at retirement, if applicable.

<sup>29</sup>Withdrawal restrictions, in general, may have prevented some realized losses during the period of the restrictions.

**Figure 4: Reasons Withdrawal Restrictions May Have Occurred Regarding 401(k) Plan Assets**



Source: GAO.

### Real Estate Accounts Restricted Withdrawals Because of Illiquid Assets

Multiple real estate accounts placed restrictions on participant and sponsor withdrawals in 2007 and 2008—some of which lasted into 2011.<sup>30</sup> Since these accounts buy and manage real estate, such as commercial properties, which is inherently more illiquid than some assets in other 401(k) investment options, industry experts we spoke to told us that few plan sponsors tend to offer these investment options in 401(k) plans. Nevertheless, some 401(k) plan participants had invested some of their 401(k) plan assets with these types of investment options and found those

<sup>30</sup>Generally, defined benefit plans are more likely to invest in real estate than defined contribution plans. As such, public reports of redemption restrictions noted that numerous defined benefit plans also experienced withdrawal restrictions from these investment options.

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assets frozen during the last few years because some of the investments in the real estate accounts—for example, an investment by the real estate fund in a high-rise building or other commercial property—had lost significant value and became difficult to sell. As a result, participants’ and plan sponsors’ withdrawals of their assets from the investment options were postponed by managers of the accounts, sometimes for multiple years.<sup>31</sup> While the number of 401(k) plan sponsors or participants whose withdrawals were affected or who lost money as a result of withdrawal restrictions is unknown, at least one lawsuit was filed on behalf of ERISA plans, including 401(k) plan participants, alleging that a service provider breached its fiduciary duties by managing a real estate account that restricted withdrawals inconsistently with its stated objective to maintain adequate liquidity to provide for daily withdrawals.<sup>32</sup> As of December 2010, some of the restrictions that were placed on these real estate accounts had been lifted, and some plan participants and sponsors had received their requested plan assets.

Industry experts told us that withdrawal restrictions on real estate accounts are not unusual—in fact such accounts have implemented withdrawal restrictions in the past—and that, for this reason, these investment options disclose to plan sponsors and participants in account documentation that the real estate account manager may temporarily freeze withdrawals. We found that plan sponsors generally receive information about real estate accounts, including the maximum number of days allowed to defer withdrawals from the account, in the contract that they sign with their service provider. In addition, we reviewed disclosures to participants that stated that the investment option was subject to investment and liquidity risk and other risks inherent in real estate such as those associated with general and local economic conditions, and that payment of principal and earnings may be delayed. However, some of the industry officials we spoke to noted that, regardless of these disclosures, participants may not have known that their plan assets could be frozen because they failed to read or understand the disclosures.

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<sup>31</sup>While restrictions were placed on participants and sponsors who wanted to withdraw to move their plan assets into other investments, a representative of the real estate accounts that we spoke to told us that, despite the restrictions, it continued to pay benefits for certain withdrawals that were defined by plan sponsors, including hardship withdrawals and withdrawals at retirement at normal age, if applicable.

<sup>32</sup>*Mullaney v. Principal Global Investors, LLC et al.* No.4:10-cv-00199-RP-TJS (U.S. Dist. Ct., So. Dist. Of Iowa)(April 30, 2010).



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## One Money Market Fund Restricted Withdrawals Because of Losses and Illiquid Assets, While Others Required Support to Prevent Potential Restrictions

While money market funds account for only a small portion of 401(k) plan assets, during 2007 and 2008, many money market funds experienced severe financial difficulties from exposure to losses from debt securities issued by structured investment vehicles and Lehman Brothers Holdings Inc. (Lehman), and one of them placed restrictions on all withdrawals from the investment option. The once-more than \$60 billion money market fund, the Reserve Primary Fund, “broke the buck” on September 16, 2008, because its \$785 million holdings of Lehman debt securities had defaulted, causing a 3 percent loss to investors, including 401(k) plan participants.<sup>33</sup> As a result of investor concern over Lehman’s default, the Primary Fund faced a very large number of withdrawal requests over a short period of time—or a run on the fund—which the other Reserve funds also experienced.<sup>34</sup> The Primary Fund stopped satisfying redemption requests and formally instituted withdrawal restrictions on all investors on September 22, 2008, when it obtained an SEC order permitting the suspension of redemptions in certain Reserve Funds, including the Primary Fund, to permit their orderly liquidation.<sup>35</sup>

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<sup>33</sup>Money market funds must operate in accordance with rule 2a-7 under the Investment Company Act of 1940. Under rule 2a-7, as in effect in 2008, money market funds were permitted to maintain a stable net asset value, usually \$1.00, by using the “amortized cost” valuation method. Under this valuation method, securities are valued at acquisition cost, with certain adjustments, instead of fair market value. If there is a difference of more than one-half of 1 percent (\$.005 per share) between amortized cost and net asset value, the fund is deemed to have “broken the buck,” and must reprice its shares. The Primary Fund’s Lehman holdings were valued at zero in September 2008 which led to a repriced net asset value of \$0.97 per share. However, these Lehman holdings were subsequently sold for around 22 cents on the dollar and thus, as of approximately July 16, 2010, Primary Fund investors had been paid 99 cents on the dollar.

<sup>34</sup>According to the “Report of the President’s Working Group on Financial Markets: Money Market Reform Options,” October 2010, money market funds are vulnerable to runs because shareholders have an incentive to redeem their shares before others do when there is a perception the fund might suffer a loss. Even when the fund suffers a small loss, shareholders who choose to redeem may do so at the expense of the remaining shareholders.

<sup>35</sup>Subject to certain exceptions, Section 22(e) of the Investment Company Act of 1940 prohibits mutual funds, including money market funds, from (i) suspending the right of redemption, or (ii) postponing payment upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of the security to the fund or its agent. One of the exceptions is by order of the SEC for the protection of the fund’s security holders. SEC issued an order covering the Reserve Primary Fund and the U.S. Government Fund on September 22, 2008, and an order covering additional Reserve money market funds on October 24, 2008.

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With the exception of the Reserve Primary Fund, the money market funds that were exposed to losses in 2007 and 2008 obtained support in some form from their advisers or other affiliated service providers that may have helped to avoid potential restrictions. This support either absorbed the losses or provided a guarantee covering a sufficient amount of losses to prevent the money market fund from breaking the buck. In addition, these funds received support from federal regulators to help them remain liquid and preserve their value. Shortly after the Reserve Primary Fund began to experience difficulties, on September 19, 2008, the Treasury announced the Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain investments in money market funds that decided to participate in the program.<sup>36</sup> On the same day, the FRB announced the creation of its Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, through which it extended credit to U.S. banks and bank holding companies to finance their purchases of high-quality asset-backed commercial paper from money market funds.<sup>37</sup> As a result of the service provider and federal support that provided additional liquidity to money market funds, additional redemption suspensions and liquidations may have been prevented.

Because of the severity of the problems experienced by money market funds during 2007 and 2008, SEC reformed its regulations governing money market funds. The new regulations are designed to make money market funds more resilient, more liquid, and to reduce the chance of runs on money market funds in the future.<sup>38</sup> Among other things, the new regulations now permit a money market fund that has broken the buck, or that is at imminent risk of doing so, and that has irrevocably decided to

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<sup>36</sup>Treasury's Temporary Guarantee Program for Money Market Funds expired on September 18, 2009. Treasury guaranteed that upon liquidation of a participating money market fund, the fund's shareholders would receive the fund's stable share price of \$1.00 for each fund share owned as of September 19, 2008. Participating funds were required to agree to liquidate and to suspend shareholder redemptions if they broke the buck. Most money market funds elected to participate in the program. On November 20, 2008, SEC adopted an interim final temporary rule under section 22(e) of the Investment Company Act that permitted investment companies that commenced liquidation under the Guarantee Program to suspend redemptions of outstanding shares and postpone payment of redemption proceeds. 17 C.F.R. § 270.22e-3T. According to SEC staff, none did.

<sup>37</sup>FRB's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility expired on February 1, 2010.

<sup>38</sup>Money Market Reform, 75 Fed. Reg. 10,060 (Mar. 4, 2010) (codified at 17 C.F.R. pt. 270 and 274). The new rules were effective May 5, 2010.

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liquidate, to suspend redemptions without obtaining an SEC order.<sup>39</sup> These changes could permit additional participant and sponsor withdrawal restrictions in the future, if additional money market funds liquidate.

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### Some Stable Value Fund Assets Were Restricted Because of Losses, Illiquid Assets, and Contract Constraints, Which Also Pose Risks to Participants

#### Some Stable Value Funds Restricted Plan Sponsor and Participant Withdrawals, but the Extent Is Unknown

Industry experts have noted that most stable value funds avoided withdrawal restrictions in 2008 and 2009, but we found that the total number of plan sponsors and participants affected by withdrawal restrictions from stable value funds was unknown. Stable value funds can place restrictions on plan sponsor and participant withdrawals in some circumstances when the market value of the fund's underlying assets is below the book value, and more participants want to cash out than the fund's cash holdings can handle. According to the Stable Value Investment Association and industry consultants, many stable value funds were operating with market values below book values in 2008 and 2009 because of losses and illiquidity in their underlying assets, but plan participants allocated increasing amounts of their 401(k) assets to stable value funds. An industry association indicated that this increase in participants' contributions to stable value funds likely allowed stable value funds to avoid liquidity problems that could have caused withdrawal restrictions or losses for participants.

However, when many stable value funds experienced market values below book values during 2008 and 2009, some participants and plan sponsors were restricted from withdrawing their plan assets from some stable value

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<sup>39</sup>Specifically, the new rule (rule 22e-3) permits a money market fund to suspend redemptions and postpone payment of redemption proceeds to facilitate an orderly liquidation of the fund if: (1) the fund's board, including a majority of the disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results to investors, (2) the board, including a majority of the disinterested directors, irrevocably has approved liquidation of the fund, and (3) the fund has notified SEC prior to suspending redemptions.

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portfolios because of stipulations in their wrap contracts. For example, after their company's bankruptcy, participants in Mervyns LLC's 401(k) plan were restricted from withdrawing their assets invested in the stable value option. In this situation, the protections that would have been afforded to the Mervyns participants by the stable value fund's wrap contract were voided by the plan sponsor's bankruptcy, since it was considered an "employer-initiated event" in the contract. Similarly, some plan sponsors were restricted from withdrawing plan assets from stable value funds because of constraining language in the wrap contract that provided for withdrawal restrictions in the case of employer-initiated events. Specifically, wrap contracts typically stipulate that stable value managers have the right to restrict plan sponsor withdrawals for employer-initiated events for up to 12 months in order to unwind investments and ensure that participants can be paid out at book value, but during this time participants are generally able to make withdrawals from the investment option at any time.<sup>40</sup> Employer-initiated events could include layoffs, bankruptcies, and changing stable value fund providers and might include anything that may cause withdrawals of a large plan asset amount from the investment option in a short time frame. For example, one plan sponsor who recently acquired another company noted that the acquisition took only 4.5 months, but it was restricted from withdrawing from the companies' two stable value funds for nearly 2 years because the acquisition, as an employer-initiated event, required a merger of the two existing stable value funds, but existing contract providers refused to accommodate the stable value fund merger without loss to participants. Another plan sponsor we spoke to noted that its 401(k) plan switched plan service providers and had to wait until the stable value fund provider had come up with enough cash to implement the change. As of the date of the switch, new contributions to the stable value option were attributed directly to the new stable value fund at the new provider, but the plan had to keep the past contributions on the plan's records until the restriction was lifted.

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<sup>40</sup>Restrictions may vary depending on the way the stable value fund is structured. 12-month restrictions, such as the restrictions described above, are generally stipulated in contracts where the stable value fund is structured as a commingled investment option. For plan sponsors who offer stable value funds as separate account investment options, there is generally no exit option, per se. Instead, for stable value funds that are operated as separate account investment options, plan sponsors generally cannot exit at book value until market values recover to that amount.

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Losses and Illiquidity in Stable Value Portfolios and Contract Constraints Increase Participants' Risks for Restrictions and Losses

The losses and illiquidity of the underlying assets of stable value funds and contract constraints that led to the withdrawal restrictions raised some concerns about the risks that these investment options pose to participants. Specifically, the industry has documented that, between 2005 and 2007, many stable value funds began including riskier assets than had been traditionally included in stable value portfolios—including highly rated corporate bonds, mortgage-backed securities,<sup>41</sup> and asset-backed securities,<sup>42</sup> at the expense of treasuries—in an effort to increase participants' return and to attract more investors. However, many of these securities suffered price declines, which contributed to the stable value funds' market values falling below their book values and has resulted in lower returns for participants. When the market value of the stable value portfolio is above book value, participants who want to withdraw their plan assets from the stable value fund receive book value, and stable value fund providers retain the extra as profit and as reimbursement for their costs to run the stable value fund.<sup>43</sup> However, as shown in table 4, when the market value of the stable value portfolio's assets is below book value, and the contract is voided by an employer-initiated event, plan participants can face withdrawal restrictions until the stable value fund generates enough cash from new contributions or by selling existing portfolio assets.<sup>44</sup>

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<sup>41</sup>Mortgage-backed securities are securities whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying mortgage loans, most commonly on residential property. For example, a bank or other entity lends a borrower the money to buy a house and collects monthly payments on the loan. This loan and a number of others, perhaps hundreds, are sold to a larger bank that packages the loans together into a mortgage-backed security. The larger bank then issues shares of this security to investors who buy them and ultimately collect the dividends in the form of the monthly mortgage payments.

<sup>42</sup>An asset-backed security is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets. The pools of underlying assets can include common payments from credit cards, auto loans, and mortgage loans, to esoteric cash flows from aircraft leases, royalty payments and movie revenues.

<sup>43</sup>Some of the amount that the provider retains may be paid back to existing or new participants through small increases in their future book value.

<sup>44</sup>Such restrictions are likely to occur in this situation if the stable value fund was structured as a commingled investment option.

**Table 4: Potential Effects on Participants if Market Value Is Below Book Value**

Wrap contract is:	What happens if many participants want to withdraw?
Valid—withdrawals do not result from employer-initiated events.	Stable value fund pays participants with cash holdings and proceeds from selling other stable value holdings. Since the stable value holdings are not enough to pay participants at book value, the wrap provider pays the difference between market value and book value. <sup>a</sup>
Void—withdrawals result from employer-initiated events that void the contract.	Stable value fund pays participants the market value of their investment in the fund with cash holdings and proceeds from selling other stable value holdings.
or	
Stable value fund restricts withdrawals until the stable value fund can provide participants with cash holdings and proceeds from selling other stable value holdings.	

Source: GAO.

<sup>a</sup>Wrap providers cover the difference between market value and book value; not the full amount necessary to pay participants who request withdrawals. For example, if the book value of a participant’s plan assets in the stable value fund is \$100, but the market value of their plan assets is only \$97, then the wrap provider would pay \$3, and the stable value fund would pay \$97 if the participant wanted to withdraw their assets.

In addition to withdrawal restrictions, when the market value of the stable value portfolio’s assets is below book value, participants are at risk for losses from the investment option. As noted above, in the case of an employer-initiated event, the wrap contract protections that would provide participants with book value could be voided, thereby placing plan participants at risk for any losses of the underlying assets.<sup>45</sup> For example, when Lehman filed for bankruptcy in September 2008, wrap contracts that covered portions of the stable value fund in the Lehman 401(k) plan became void, which resulted in losses for some plan participants who withdrew their plan assets from the investment option. Furthermore, even if the wrap contract remains valid, if more participants request transfers out of the investment option when the market value of the fund is less than book value than the fund’s liquidity reserves can handle, new participants and participants who remain in the fund could be at risk for the losses from the investment option because the rate of return earned on the stable value fund, going forward, will be adjusted downward by the wrap contract provider to reflect the market losses that were temporarily

<sup>45</sup>Depending on the specific situation, some plan sponsors may be able to negotiate with the stable value fund provider to continue to provide book value to participants, even though an employer-initiated event has occurred. However, if the plan sponsor is able to negotiate with the wrap provider or find a new wrap provider who will accept the losses on the original contract, participants who are covered under the renegotiated or new contract will likely be charged a higher fee to make up for the losses.

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**Stable Value Wrap Contracts  
Also Expose Participants to  
Other Risks**

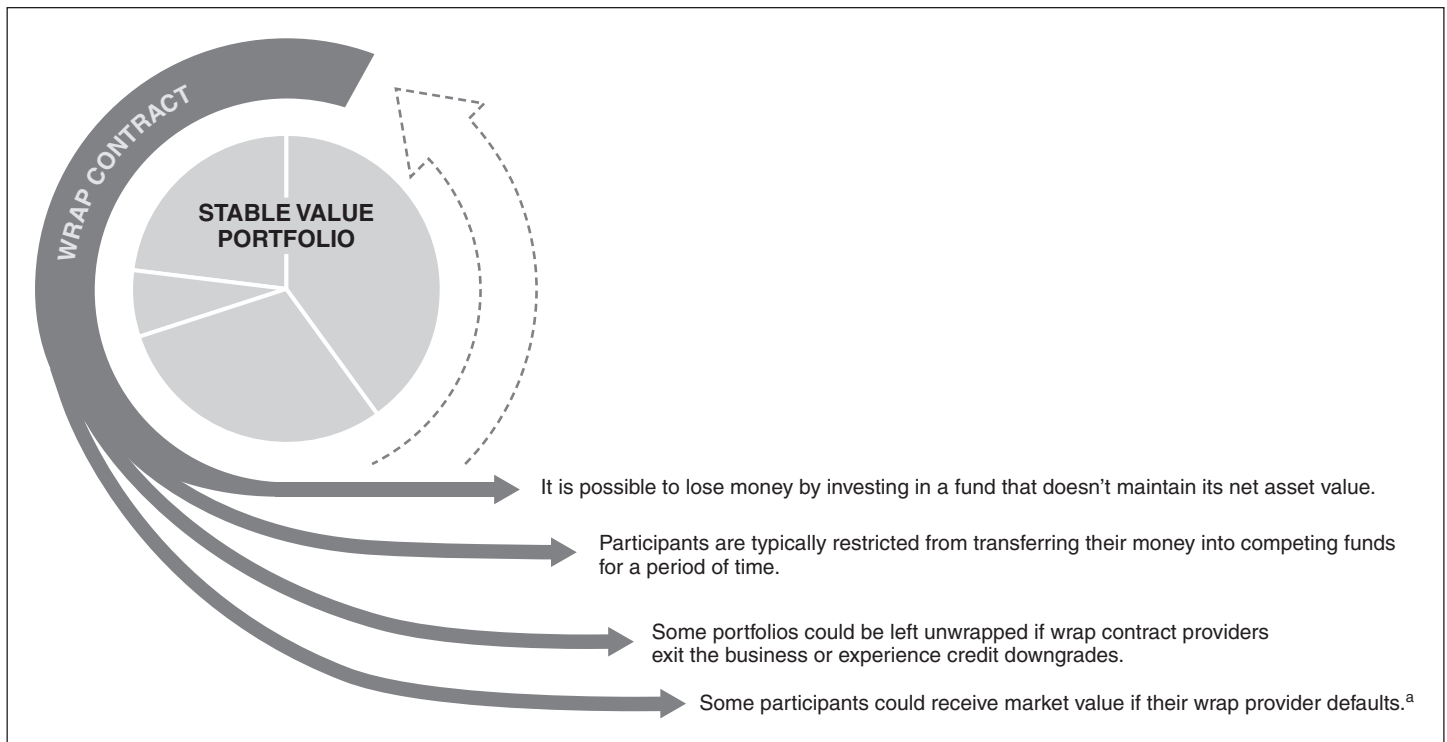
covered by the wrap provider.<sup>46</sup> In fact, industry experts note that wrap providers had never made a payment in fulfillment of a wrap contract that they did not recoup. As a result of the adjusted rate of return, future assets contributed to the stable value fund, whether by current or new participants, will earn less than the original assets that incurred the losses because the wrap provider will guarantee a lower return for those future contributions in order to make up for the market losses. Although one of the reasons why stable value fund providers place restrictions on plan sponsor and participant withdrawals is to limit these situations, even unrestricted participant withdrawals could trigger an inequitable distribution of risk and losses. This is of particular concern when interest rates have risen sharply, and investors leave the stable value fund in search of higher yields.

In addition to causing potential losses for participants, wrap contracts can also expose participants to other risks. Figure 5 illustrates some of the potential risks associated with stable value fund wrap contracts.

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<sup>46</sup>If participants request transfers out when the market value of the fund is less than book value, the cash held by the stable value fund has been exhausted, and the withdrawal requests are not related to an employer-initiated event, the wrap contract will partially cover the difference between the market value and book value of the withdrawals. The wrap provider pays participants only if there is a deficit between book value and market value after all participants have left the plan.

**Figure 5: Potential Risks Associated with Stable Value Fund Wrap Contracts**



Source: GAO interviews and analysis of stable value fund issues.

<sup>a</sup>One of the major wrap contract providers almost went bankrupt, requiring a federal bailout.

- “Competing” fund restrictions—If participants wish to withdraw their assets from a stable value fund, the terms of the wrap contract may prohibit them from transferring their assets into “competing” investment options offered by the plan sponsor, as defined in the wrap contract. Participants may instead be required to put their assets into a noncompeting investment option for 90 days.<sup>47</sup> Because these funds are intended to be longer term investments, these restrictions are typically included in the wrap contract to prevent participants from taking of

<sup>47</sup>These wrap contract restrictions are sometimes called “equity wash provisions” because once the participant transfers their plan assets out of the stable value fund, they are precluded by the contract from investing their plan assets directly into “competing” investment options, which could include money market funds or other short-term fixed income funds, and instead are required to put their money in a non-competing investment option, such as an equity fund.



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advantage of interest rate fluctuations; however, they still represent a risk to participants since they are prevented from directing their assets.

- Rising fees for wrap contracts—Industry experts note that wrap contracts have gotten more expensive in recent years as wrap providers also became aware of the significant risks taken in stable value fund portfolios. For example, one stable value fund provider stated that, as of March 2010, virtually all wrap providers had ceased accepting new stable value portfolios unless the contracts stipulated new contract terms—including tougher investment parameters and higher fees—which were more favorable for wrap providers but could create unwelcome inflexibility for plan sponsors.<sup>48</sup> Such higher fees for wrap providers, everything else equal, could also result in lower returns for participants. Wrap capacity has also recently been constrained because some wrap providers left the market, and others saw decreases in their credit ratings. Because of this, some stable value funds have had difficulty obtaining wrap contracts on portions of their underlying stable value portfolios, which has increased the likelihood that participants could bear potential losses from the underlying investments in stable value funds. For example, AIG, one of the major wrap providers, no longer provides wrap contracts.<sup>49</sup> Similarly, according to industry reports, a few other firms, including UBS and Rabobank, decided to stop providing wrap coverage. These developments would also tend to place upward pressure on fees.<sup>50</sup> While some providers have entered the market, and other stable value fund providers have agreed to provide this coverage for their plan sponsors until they can obtain a wrap contract, wrap capacity is not yet back to previous levels.

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<sup>48</sup>Some plan sponsors have also called for less risk to be taken in the stable value portfolio.

<sup>49</sup>According to a Congressional Oversight Panel June 10, 2010 report, *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy*, on the day that AIG was poised to fail, it had \$38 billion in stable value wrap contracts.

<sup>50</sup>The combined effects of wrap providers exiting the business, credit downgrades in the insurance industry, and reevaluations of risk in the historically “low-risk” wrap contract business caused the majority of remaining wrap providers to significantly reduce their risk exposure, triggering much tighter investment restrictions on the underlying stable value portfolio and increasing fees.

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## Certain Investment Options That Lent Securities Placed Restrictions on Plan Sponsor Withdrawals Because of Losses and Illiquid Assets in the Cash Collateral Pool, Which Also Posed Risks to Participants

We also found that some restrictions were placed on investment options that lent securities. Any number of 401(k) investment options can lend securities, including index funds, money market funds, and stable value funds. Some service providers that offered the investment options that lent securities did not allow plan sponsors to withdraw or transfer all of the 401(k) plans' investments in those investment options because of collateral pool losses.<sup>51</sup> These losses occurred because the cash collateral pools had been invested in risky assets that subsequently lost value and became difficult to trade.<sup>52</sup> As a result of the losses, the pools were not worth the amount that the investment option needed to return the cash collateral and pay rebates to borrowers.<sup>53</sup> During the period of withdrawal restrictions, some plan sponsors were allowed to withdraw only a certain percentage of their plan's assets in the investment option over a given time period—in many cases 2 to 4 percent—or they were required to take their share of the cash collateral pool's illiquid and devalued assets.<sup>54</sup>

Similar to stable value funds, the losses and illiquid assets in the cash collateral pools that led to these restrictions on plan sponsor withdrawals raised concerns about the risks this practice poses to participants' account balances, given the returns they receive. In the case of securities lending

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<sup>51</sup>Some investment options that were registered with SEC, such as mutual funds, also experienced realized and unrealized cash collateral pool losses but did not place restrictions on plan sponsors' withdrawals because of the losses. Instead, realized cash collateral pool losses were included in the net asset value of the registered investment option.

<sup>52</sup>These assets may not have been perceived as risky when they were acquired and, in fact, may have complied with the plans' or the investment options managers' investment guidelines covering cash collateral reinvestment. Some investment guidelines were very broad and therefore provided some discretion to the lending agent. As a result, some lenders may have chosen more aggressive reinvestment strategies when more conservative approaches were available.

<sup>53</sup>This is known as a "collateral deficiency" and, as used here, occurs when the securities lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption.

<sup>54</sup>Securities lending agents had differing experiences in their respective cash collateral pools, and managed their clients' realized and unrealized losses differently—some placed restrictions on plan sponsor withdrawals. In addition, the restrictions varied by the type of investment options that plan sponsors offered. On one hand, investment options that were separate accounts required that a minimum percentage of the account's securities had to be lent out. However, investment options that were commingled accounts virtually eliminated plan sponsors' abilities to withdraw from the commingled accounts, limiting withdrawals to between 2 and 4 percent of their assets per month.

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with cash collateral, participants bear the ultimate risk of loss from the cash collateral pool investments.<sup>55</sup> While securities lending agents may bear counterparty risk from securities lending activities with cash collateral—i.e., reimburse plan participants for losses caused by borrower default—they generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer, which is the risk that remains with plan participants. However, in the event that there were gains from the investments of the cash collateral pool, participants only receive a portion of return, while securities lending service providers, including broker-dealers and securities lending agents, may obtain most of the gains earned on cash collateral reinvestment.<sup>56</sup> In addition, some securities lending agents reported large portions of their annual revenues from the returns earned by cash collateral reinvestment activities for their institutional investors, including 401(k) plans.<sup>57</sup> In 2008, one of the largest securities lending agents reported that its revenues from such lending were over \$1 billion. See figure 6 for a breakdown on the return that participants can receive.

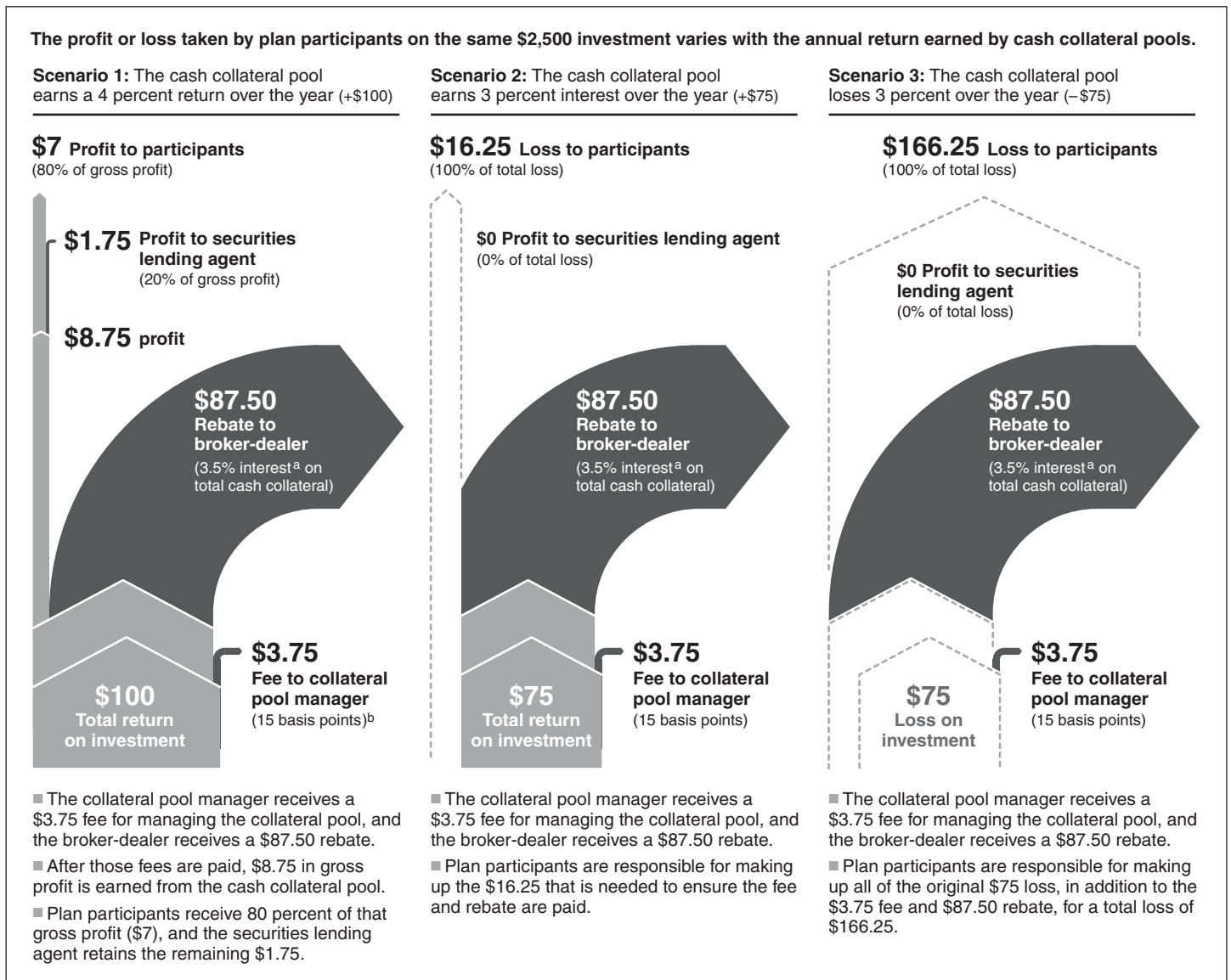
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<sup>55</sup>Participants ultimately bore the risk of loss from market risks of the cash collateral portfolio—the potential for portfolio losses resulting from the change in value of stock prices of the portfolio’s assets, interest rates, foreign exchange rates, and commodity prices—but were only provided with a portion of the return generated as a result of the risks taken on their behalf.

<sup>56</sup>According to individuals we interviewed, broker-dealers may negotiate to receive a rebate from the securities lending agent of some of the return earned on the reinvestment of cash collateral because they would have earned a short-term rate of return on the cash they provided as collateral if they had kept it in their possession. However, since they are providing the cash as collateral, they are not able to earn interest on it.

<sup>57</sup>The lending agent typically absorbs the operational expenses associated with providing the service.

**Figure 6: Gain or Loss Earned on Reinvestment of Cash Collateral from Securities Lending in Differing Market Scenarios**



Source: GAO interviews and analysis of the practice of securities lending with cash collateral reinvestment.

Note: All of these scenarios are based on certain assumptions. The rates were chosen to depict a situation that may have been in effect in the years/months prior to and at the beginning of the crisis. While today's rates may vary from the rates depicted here, the distribution of gains/losses will not likely differ materially for the same type of securities loan. Thus, in this example,

- The securities lending agent contracts with (1) the plan sponsor to allow the plan's assets to be lent and (2) with the broker-dealer to lend the assets,

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- The security lent is not a “special” security—or a security that is sought after in the market by borrowers,
  - The total amount of cash collateral as a result of the securities lending transaction, \$2,500, is provided by the broker-dealer at the beginning of the year and the securities lending transaction remains in effect throughout the year,
  - The securities lending agent reinvests all of the cash collateral provided by the broker-dealer in a cash collateral pool managed by the collateral pool manager, who charges 15 basis points of the total amount of cash collateral to manage the pool (\$3.75),
  - The broker-dealer is promised a rebate—an annualized return of 3.5 percent interest on the total amount of cash collateral they provide over the year (\$87.50), and
  - The plan sponsor agrees to an 80/20 revenue sharing split between plan participants and the securities lending agent, which means that participants get 80 percent, and the lending agent gets 20 percent of the revenue earned from the cash collateral pool after fees are paid.

<sup>a</sup>Typically, the rate promised to the broker-dealer as a rebate is based on a benchmark rate, such as the federal funds rate or LIBOR and is not typically provided in a one-time payment as shown in the graphic, but more likely paid on a daily or monthly basis. The greater the demand for the security being lent, the lower the rebate paid to the broker-dealer. “Special” securities that have an extremely high borrowing demand, or that are in short supply and therefore hard to borrow, can obtain “negative” rebates, requiring the borrower to not only pledge cash, but also pay a fee to plan participants.

<sup>b</sup>15 basis points is the same as 0.15 percent.

Because securities lending agents typically do not bear the risk of loss of the collateral pool, yet gain when the collateral pool makes money, they may be encouraged to take more risks with the underlying assets of the investment options—both by investing in riskier assets and by delaying the sale of those assets. Some cash collateral pool managers invested in certain assets that increased the risk of the pool. These assets were of questionable credit quality or required a longer duration of investment than the typical plan assumed were in the cash collateral pool. For example, prior to September 2008, some pools had invested in Lehman Brothers Holdings, Inc., securities that became almost worthless in 2008, making them too illiquid to pay all withdrawal requests.<sup>58</sup> Furthermore, we found that plan sponsors may have also had the incentive to offer investment options that lent securities more aggressively because those investment options offered higher returns, yet were still marketed as

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<sup>58</sup>While Lehman may have had a high credit rating immediately prior to its bankruptcy, that rating may have been based on materially misleading periodic reports. In fact, the report of the Examiner in Lehman’s bankruptcy proceedings stated that “unbeknownst to the investing public, rating agencies, Government regulators, and Lehman’s Board of Directors, Lehman reverse-engineered the firm’s net leverage ratio for public consumption.”

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relatively “risk free.” Thus, in trying to offer participants investment options that provided competitive returns, plan sponsors may have searched out investment options that may have, as a result of securities lending with cash collateral, increased participant risks in the process of seeking higher returns.<sup>59</sup>

In addition to withdrawal restrictions, these risky assets in securities lending cash collateral pools caused realized losses for participants in the last few years.<sup>60</sup> A recent industry publication estimated that unrealized losses in securities lending cash collateral pools affected most pension plans and many defined contribution plans, but some 401(k) plans also experienced realized cash collateral pool losses in 2008. In addition, some retirement plans, including 401(k) plans, have recently filed lawsuits against some of the larger securities lending agents as a result of these losses.<sup>61</sup> The litigation claims included allegations of violations of the lending agents’ fiduciary, contractual, and other legal responsibilities in losing millions of dollars for the investment funds in their securities lending contracts. In addition, several securities lending agents have requested and received individual prohibited transaction exemptions from Labor that have allowed them to reduce some of the cash collateral pool

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<sup>59</sup>Many investment options, by design, invest in securities with some risk. If the securities are lent out and the cash collateral is then invested in risky securities, it creates a leveraged situation where \$1 invested in the fund is exposed to more than \$1 of risk. To the extent that returns on the two sets of risky assets are correlated, a market downturn could result in both the lent securities, and the collateral investments suffering losses at the same time.

<sup>60</sup>Losses may have been realized or unrealized. Realized losses caused the value of the investment option to decline and were less likely to cause withdrawal restrictions, whereas unrealized losses did not cause the value of the investment option to decline and were more likely to cause withdrawal restrictions.

<sup>61</sup>For example, BP Corporation pension plan committee filed suit in October 2008 against Northern Trust Company, asserting multiple causes of action grounded in the fiduciary obligations prescribed by §§ 404, 409, and 502 of ERISA. This case is still pending, and no rulings have been made. *BP Corporation North America, Inc. Savings Plan Investment Oversight Committee v. Northern Trust Investments N.A.*, No. 1: 08-cv-6029 (N.D. Ill.)(October 21, 2008). Other cases include: *Public School Teachers’ Pension & Retirement Fund of Chicago et.al. and City of Atlanta Firefighters’ Pension Plan, v. Northern Trust Investments*, No. 1:10-cv-00619 (N.D. Ill.)(January 29, 2010); *Board of Trustees of the AFTRA Retirement Fund et.al. v. J.P. Morgan Chase Bank N.A.*, No. 1:09-cv-00686-SAS-DCF (S.D. N.Y.)(January 23, 2009); and *Diebold v. Northern Trust Investments N.A. et.al.*, No. 1:09-cv-01934 (N.D. Ill.)(March 30, 2009). We did not verify the status of these cases.

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losses.<sup>62</sup> Specifically, these exemptions allowed securities lending agents either to buy the problematic securities from a number of cash collateral pools that held pension plan and 401(k) plans assets or to shore up those pools with cash in an attempt to create liquidity in the otherwise cash-strapped collateral pools.<sup>63</sup>

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### Disclosures about Stable Value Funds and Securities Lending Are Limited and Difficult for Participants to Understand

Given the risk and limitations that participants are exposed to when investing in stable value funds, information provided to participants may be difficult for them to understand and may not fully explain the risks taken on their behalf by stable value funds, including the variety of events that could affect participants' withdrawals or that could cause losses. See figure 7. While participants receive some disclosures about stable value funds and some of the risks associated with investing in them, industry experts found in 2009 that participants often are not able to understand those disclosures.<sup>64</sup> For example, a defined contribution consulting firm recently expressed concern over participants' perception that these investment options are risk-free and recommended that stable value funds should be required to make a statement explaining how such a fund is managed and identifying the risks associated with the fund, such as the underlying assets, the wrap providers, and the wrap contract.

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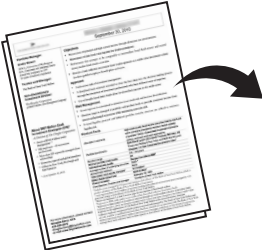
<sup>62</sup>Individual exemptions relating to actions taken by service providers to ensure liquidity of cash collateral pools were granted by Labor in 2009 and 2010, including PTE 2009-11, JP Morgan Chase Bank, National Association; PTE 2009-27, Bank of New York Mellon Corporation; and PTE 2010-25, State Street Bank and Trust Company.

<sup>63</sup>For example, one securities lending agent contributed cash to one of their cash collateral pools that experienced losses as a result of the Lehman default—in accordance with their portion of the split on gross profit—but sponsors that withdraw from the cash collateral pool within three years will forfeit this loss sharing. Another securities lending agent contributed cash representing 20 percent—or the loss from a Lehman security—of the unrealized and realized losses in one of their collateral pools.

<sup>64</sup>ERISA Advisory Council. *Report on Stable Value Funds and Retirement Security in the Current Economic Conditions* (2009).

**Figure 7: Example of a Stable Value Fund Disclosure Provided to 401(k) Participants**

**Excerpts from a two-page stable value fund fact sheet** (text shown actual size)



**Risk Management**

- Issuer exposure is constrained to minimize issuer credit risk and increase diversification.
- Duration target is managed at portfolio and product levels to provide consistent income from interest and principal repayments while minimizing convexity risk.
- A tiered liquidity protocol and laddered portfolio maturity structure are utilized to minimize liquidity risk.

... actual investment advisory fees incurred by clients may vary depending on account size and other account-specific factors. The ... investment advisor's (The De...

... It should not be assumed that any of the securities transactions or holdings listed or discussed were or will be profitable, or that the investment recommendations or decisions we will make in the future will be profitable or will equal the investment performance of the securities listed or discussed herein.

Source: GAO presentation of a private investment company's fact sheet for a stable value fund.

Furthermore, it is unclear to what extent stable value fund disclosures include a discussion of all of the risks that participants could be exposed to and all of the information participants need to evaluate the benefits and risks of the investment option. Labor published final participant disclosure regulations in October 2010 that will affect the disclosures participants receive about investment options, including stable value funds.<sup>65</sup> One industry expert we spoke to said that while the newly required disclosures clearly include participant restrictions defined in the stable value contracts, such as restrictions on transferring plan assets into competing

<sup>65</sup>Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule, 75 Fed. Reg. 64,910 (Oct. 20, 2010)(codified at 29 C.F.R. pt. 2550). As a result of these regulations, which became effective on December 20, 2010, participants will receive core information about investments available under the plan, including performance and fee information, prior to investing and on an annual basis, in a chart or similar format designed to facilitate investment comparisons. Participants will also receive quarterly statements on plan fees and expenses deducted from their accounts along with a description of the services for which the charge or deduction was made. 29 C.F.R. § 2550.404a-5 and § 2550.404c-1.



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funds, the expert did not believe that the potential for restrictions of stable value withdrawals based on employer-initiated events would be included in these new disclosures to participants. In addition, industry experts we talked to said that participants were frequently not given an important piece of information—the market to book value of the stable value portfolio—unless they asked for it. In fact, some experts said that plan sponsors may not be inclined to provide this information to participants for fear that it would cause what would be deemed an employer-initiated event.<sup>66</sup> While one expert believed that participants would continue to receive disclosures from stable value funds about the stable value funds' book values, the expert did not believe that the market value of the stable value portfolio would be required by Labor's recently published participant disclosure regulations. One industry expert stated that the ratio of market to book value of the stable value portfolio was the summary statistic that would help plan participants understand whether their investments are at risk if the other participants in their plan withdraw from the fund. While Labor's recent regulations may address some of these risks in a requirement that the participant disclosures include an Internet Web site address that provides participants access to the investment option's principal strategies and principal risks, it is unclear whether participants will find this method of disclosure useful in understanding the specific risks associated with stable value funds and comparing those risks with the risks posed by other investments.

Participants may also be unaware of the risks taken on their behalf by investment options that lend securities, including the complex compensation structures and variety of events that could affect participants' withdrawals or that could cause losses. As with stable value fund disclosures, disclosures regarding the risks associated with engaging in securities lending with cash collateral reinvestment are generally also buried deeply within the pages of investment option documents and, as written, may give the incorrect impression that any financial risk to plan assets is low. In one mutual fund's annual report, the fact that the investment option engages in securities lending is disclosed on page 68 of

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<sup>66</sup>Wrap contracts may stipulate plan sponsor communications with participants that induce transfers from the funds as employer-initiated events.

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the 90 page document.<sup>67</sup> Figure 8 shows pertinent information about securities lending that would be provided to a plan participant from another investment option, an index fund, registered with the SEC. The figure shows page 14 of a 52-page document. The 52-page document is the “Statement of Additional Information” (SAI) which is a supplementary document to a mutual fund’s prospectus that contains additional information about the mutual fund and includes further disclosure regarding its operations. There is also a 37-page annual report, as well as a 40-page prospectus for the index fund.

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<sup>67</sup>The placement of this information in disclosure documents depends on the investment option’s approach to securities lending. If, for example, the investment option only lends on an intrinsic value basis, and only reinvests cash to preserve principal, their risk may in fact be low. Since the economic crisis, securities lenders are calling for a move towards an intrinsic value lending approach, rather than a focus on cash collateral reinvestment to generate additional returns.

**Figure 8: Example of a Securities Lending Disclosure in Registered Investment Option’s Required Disclosures**



**Excerpt from page B-14 of one 52-page “Statement of Additional Information”** (text shown actual size)

**Securities Lending.** A fund may lend its investment securities to qualified institutional investors (typically brokers, dealers, banks, or other financial institutions) who may need to borrow securities in order to complete certain transactions, such as covering short sales, avoiding failures to deliver securities, or completing arbitrage operations. By lending its investment securities, a fund attempts to increase its net investment income through the receipt of interest on the securities lent. Any gain or loss in the market price of the securities lent that might occur during the term of the loan would be for the account of the fund. If the borrower defaults on its obligation to return the securities lent because of insolvency or other reasons, a fund could experience delays and costs in recovering the securities lent or in gaining access to the collateral. These delays and costs could be greater for foreign securities. If a fund is not able to recover the securities lent, a fund may sell the collateral and purchase a replacement investment in the market. The value of the collateral could decrease below the value of the replacement investment by the time the replacement investment is purchased. Cash received as collateral through loan transactions may be invested in other eligible securities. this cash subjects that investment to market appreciation or depreciation.

The terms and the structure of the loan arrangements, as well as the aggregate amount of securities loans, must be consistent with the 1940 Act, and the rules or interpretations of the SEC thereunder. These provisions limit the amount of securities a fund may lend to 33 1/3% of the fund’s total assets, and require that (1) the borrower pledge and maintain with the fund collateral consisting of cash, an irrevocable letter of credit, or securities issued or guaranteed by the U.S. government having at all times not less than 100% of the value of the securities lent; (2) the borrower add to such collateral whenever the price of the securities lent rises (i.e., the borrower “marks-to-market” on a daily basis); (3) the loan be made subject to termination by the fund at any time; and (4) the fund receive reasonable interest on the loan (which may include the fund’s investing any cash collateral in interest bearing short-term investments), any distribution on the lent securities, and any increase in their market value. Loan arrangements made by each fund will comply with all other applicable regulatory requirements, including the rules of the New York Stock Exchange, which presently require the borrower, after notice, to redeliver the securities within the normal settlement time of three business days. The advisor will consider the creditworthiness of the borrower, among other things, in making decisions with respect to the lending of securities, subject to oversight by the board of trustees. At the present time, the SEC does not object if an investment company pays reasonable negotiated fees in connection with lent securities, so long as such fees are set forth in a written contract and approved by the investment company’s trustees. In addition, voting rights pass with the lent securities, but if a fund has knowledge that a material event will occur affecting securities on loan, and in respect of which the holder of the securities will be entitled to vote or consent, the lender must be entitled to call the loaned securities in time to vote or consent.

Source: GAO presentation of a private investment company’s Statement of Additional Information for an index fund.

In general, 401(k) participants do not receive the SAI or the prospectus automatically, although plan sponsors do receive a prospectus, and so do retail investors. Therefore, participants may never see this disclosure on

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securities lending. One plan sponsor we spoke to, described the SAI as an attachment to the prospectus. The sponsor told us that it is necessary to know where to find this information and then work through the details. All disclosure information is embedded in massive documents of varying degrees of importance. Labor's recently issued participant disclosure regulations will undoubtedly affect the disclosures participants receive. Participants will receive core information about investments available under the plan, including performance and fee information, in a chart or similar format designed to facilitate investment comparisons. However, since these regulations require only disclosure of investment options, and not all practices utilized by those investment options—of which securities lending is one practice—it is unclear how much or to what extent securities lending fees and risks will be discussed in these disclosures.<sup>68</sup> There is nothing in the regulations that explicitly requires plan sponsors to disclose information on the risks of securities lending with cash collateral reinvestment or withdrawal restrictions that can result from securities lending. Without better disclosures on securities lending with cash collateral, participants may continue to be unaware of the practice of cash collateral reinvestment and the risk it poses to plan participants, as well as the potential for withdrawal restrictions resulting from such practices.

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<sup>68</sup>29 C.F.R. § 2550.404c-1.

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## Labor Can Take Steps to Help Plan Sponsors Understand the Risks and Challenges Posed By Certain Investments and Practices

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### Eliminating Stable Value Fund Restrictions That Can Compromise Sponsors' Fulfillment of Their Fiduciary Obligations and Providing Better Information Can Help Plan Sponsors

Stable value funds are typically subject to restrictions and wrap contracts that may prevent plan sponsors or fiduciaries from meeting their fiduciary obligations when choosing to offer a stable value fund.<sup>69</sup> A stable value fund contract can constrain a plan sponsor's ability to add investment options or communicate information about the basic health of the investment option to participants. In addition, stable value fund contractual arrangements can discourage plan sponsors from communicating with their plan participants about the levels of risk the particular investment options were assuming. These types of arrangements that limit sponsor behavior and that may void the stable value contract, however, are not prohibited by current regulation, and experts told us that they are commonly accepted industry practices.

The wrap contracts associated with stable value funds may cause problems for plan sponsors because they typically limit the type of information that can be shared with participants. Wrap contracts typically prohibit sponsors from making any communication that may result in fund redemptions. This can complicate the plan sponsor's role in administering the plan. For example, in a situation where a sponsor becomes aware that the market value of the stable value fund's underlying assets has fallen below book value, which could put participant assets at risk, the sponsor is in a unique position—if the sponsor communicates this information to

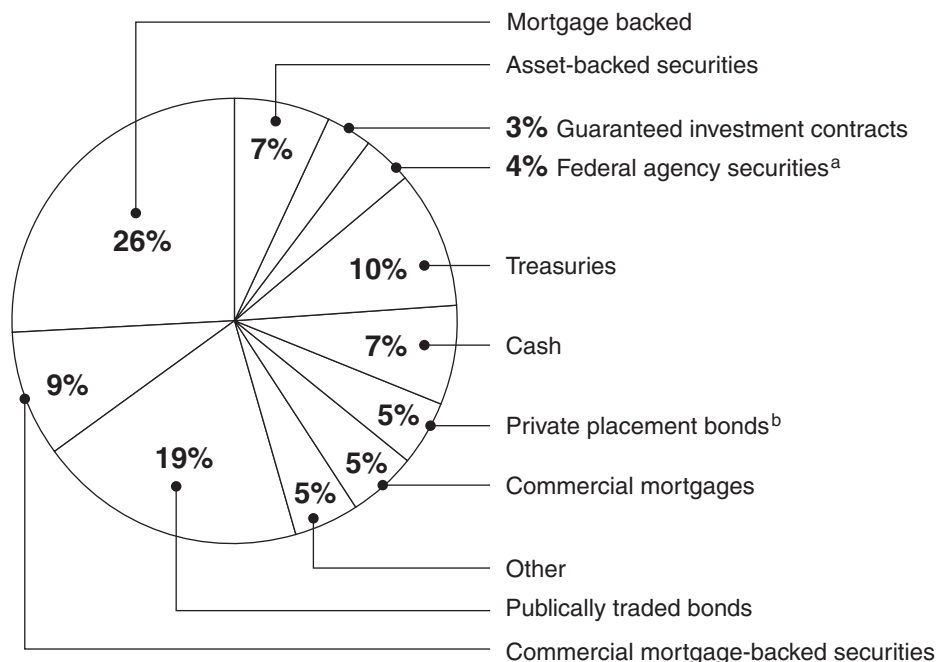
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<sup>69</sup>Section 404(a)(1) of Title I of ERISA provides a "prudent man standard of care" that a fiduciary must observe in meeting his or her duties with respect to the plan. As such, the fiduciary must act solely in the interests of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Among other requirements, the fiduciary must discharge his responsibilities with the appropriate care, skill, prudence, and diligence that similarly situated fiduciaries acting in a like capacity and familiar with such matters would use in a similarly situated enterprise of a like character and with like aims. 29 U.S.C. § 1104(a)(1).

participants, it would likely void an insurance contract that could be valuable to the plan's participants. However, failing to communicate this information to participants may compromise the plan sponsor's role as a fiduciary with respect to the plan.

During our review, industry experts told us that sponsors of varying plan sizes often lacked an understanding of the underlying investments and the features of stable value funds. Stable value funds are marketed to plan sponsors as low-risk investments that provide consistent stable returns, protection of the invested principal, and immediate liquidity, characteristics that have attracted many sponsors and participants to stable value funds. Stable value funds are also considered to be invested in high-credit quality, fixed income securities, such as low-risk, government and corporate bonds with short- to medium-term maturities. Yet, as shown in figure 9, as of the end of 2008, nearly 50 percent of the underlying assets in stable value funds were asset-backed or mortgage-backed securities.

**Figure 9: Underlying Assets in Stable Value Funds (year end 2008)**



Source: Stable Value Investment Association's 13th Annual Stable Value Investment and Policy Survey.

<sup>a</sup>Federal agency securities are debt instruments issued by federal credit agencies.

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<sup>b</sup>A private placement is a direct offering of securities directly to an institutional investor, such as a bank, mutual fund, insurance company, pension fund, or foundation.

Given their mix of underlying assets, many stable value funds' credit rates dropped sharply in 2008 and 2009 because of lower returns on their underlying bond holdings and market conditions that prompted stable value managers to put more money into cash during the financial crisis. Despite the problems that stable value funds experienced during 2008 and 2009, investors continued to put money into stable value funds as they sought a less risky investment which helped to shore up stable value returns.

Labor's ERISA Advisory Council reported in 2009 that plan sponsors need, among other things, a better understanding of a stable value fund's portfolio composition, the current financial condition of fund issuers and wrap providers, and the safeguards they each have in place in the event of default.<sup>70</sup> The council reported that only with this critical information can plan sponsors adequately determine the appropriateness of selecting a particular stable value fund or whether such an investment meets the needs of the plan. The council heard testimony that such information may either not be readily available from wrap providers or stable value fund managers or that plans sponsors do not know to ask for, or do not understand, the information that might be made available. Without this information, plan sponsors may continue to offer stable value funds to plan participants, the associated risks of which they and plan participants may not clearly understand.

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<sup>70</sup>An asset in a stable value fund can potentially default, for example, if the loan underlying an interest-only bond defaults or prepays. A wrap provider can potentially default on its "guarantee" or its obligation to cover any gap between market value and book value of a stable value fund's assets.

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**Example of an Employer-Initiated Event That Could Void the Stable Value Wrap Contract**

A common sponsor response to an underperforming fund is to replace it with another fund. However, in the case of a stable value fund that has a market value below book value, replacing the stable value fund could invalidate the wrap protection, or at least trigger clauses in the contract that might delay the liquidation of the fund. Some funds allow the option of a "12-month put," in other words, a 1-year advance notice required to terminate a fund, while others may not allow termination of the fund until market value and book value converge. A sponsor may be faced with the difficult choice of either maintaining an underperforming stable value fund or voiding an insurance contract that may be potentially valuable to their plan participants.

Labor's ERISA Advisory Council also reported that plan sponsors need more information with regard to a stable value fund's underlying assets, including how those funds are valued, its wrap provider, and a fund's costs and fees.<sup>71</sup> In addition, understanding the events that could void a wrap contract could help plan sponsors make strategic decisions. The stress of the market volatility in 2008 and 2009 (which led to lower market values for many stable value funds) has placed increased scrutiny on sponsor behavior that might be considered an employer-initiated event according to the terms of wrap contracts and highlighted the need for plan sponsors to have a better understanding of all the implications of their decisions regarding the wrap provisions of their stable value funds.

According to industry reports, some plan sponsors are now asking for more flexibility in their wrap contract provisions and, as a result, some stable value fund providers are starting to offer options that might provide that flexibility. One stable value fund provider stated that one of the concerns about stable value funds that came to light as a result of the 2008 financial crisis was that wrap contracts may have been too inflexible to provide plan sponsors with the ability to make necessary business decisions, such as closing a plant or layoffs, without affecting their stable value fund options in their 401(k) plans. The stable value fund provider stated that plan sponsors may view the embedded protections in wrap contracts that would preclude them from making these decisions as too constraining and has thus begun to offer some plan sponsors with choices that provide greater flexibility. For example, the stable value fund provider is offering its plan sponsors two stable value fund choices that seek to provide them with flexibility for employer-initiated events or participant communications and a greater likelihood that they will not void the contract if they make changes to their plans. While these flexibilities in the terms of wrap contracts may be offered to some plan sponsors, not all plan

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<sup>71</sup>According to the ERISA Advisory Council, plan sponsors need (1) issuer specific information regarding the underlying assets of a stable value fund for insight into the risk/reward characteristics that will result in any variance between the fair market value and the book value; (2) issuer specific information regarding the wrap contract provider, since the financial stability of the wrap contract provider(s) may be a factor in the ability of the fund to be able to continue to make payments at book value when book value is greater than the fair market value of the underlying assets; (3) information on the administrative cost and other fees related to the fund, to aid in determining the efficiency and prudence of the investment; and (4) information concerning the periodic fair market valuation of the fund as compared with book value that would allow them to evaluate any risk of a market value adjustment.



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sponsors are able to negotiate special terms to protect their plan participants or themselves.<sup>72</sup>

Recently enacted legislation requires Labor and other regulators to review various aspects of stable value fund contracts, providing Labor an opportunity to aid plan sponsors and participants in better understanding stable value funds. Specifically, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),<sup>73</sup> prescribes that the SEC and the Commodity Futures Trading Commission (CFTC) jointly conduct a study to determine whether stable value contracts fall within the definition of a swap.<sup>74</sup> Given that Labor will be required to inform the study, the agency is in a unique position to focus on ways to help plan sponsors better understand stable value funds.

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<sup>72</sup>Industry experts who testified before the ERISA Advisory Council stated that the level of due diligence for stable value fund selection is qualitatively different from the due diligence in selecting a mutual fund. Unlike mutual funds, where there are a variety of sources regarding their current and historic value, the only source of stable value fund information is the stable value fund provider. Thus, some plan sponsors are in a position where they not only do not understand the composition and diversification of the underlying portfolio of stable value funds, but they also do not understand how the market to book value of their plan's stable value fund compares to other stable value funds.

<sup>73</sup>Pub. L. No. 111-203, §719, 124 Stat. 1377, 1656 (2010). The Dodd-Frank Act was signed into law on July 21, 2010. The stated intent of the new law is to promote the financial stability of the United States by improving the accountability and transparency in the financial system and protecting consumers from abusive financial services practices.

<sup>74</sup>Swaps are one of the financial transactions addressed by the Dodd-Frank Act. Normally, the vast majority of retirement plans do not directly employ swaps. However, the Dodd-Frank Act's definition of swap could include components of stable value fund products because the Dodd-Frank Act defines "swap" broadly to include certain agreements where the value is determined by reference to an underlying asset (subject to certain exclusions). The investments underlying a stable value fund are protected by the issuer's guarantee to pay the book value of the investments if the market value is depleted. It is this protective wrap contract that could be considered a swap under the Dodd-Frank Act. SEC and CFTC are to consult with Labor, Treasury, and state regulators who regulate the issuers of stable value contracts and issue a report by October 11, 2011. If they determine that stable value contracts fall within the definition of a swap, they are to determine if an exemption is in the public interest. Until such time, the requirements of the act are not to apply to stable value contracts and stable value contracts in effect prior to the adoption of any regulations are not to be considered swaps. Section 719(d) of Dodd-Frank 15 U.S.C. § 8307.

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## Changes to Labor’s Disclosure Regulations Can Also Help Plan Sponsors Become Aware of the Risks Associated with Investment Options That Lend Securities

Industry experts told us that many plan sponsors are unaware of the risks involved with the cash collateral reinvestment portion of their service providers’ securities lending programs, or may not fully understand the risks. Other plan sponsors may not know whether their investment options engage in such lending at all. For example, 17 of the 74 plan sponsors who responded to our brief poll responded “no” to our question about whether their investments that engage in securities lending had disclosed to them that this investment practice was a possibility. An additional 20 plan sponsors responded that they were not sure whether this information had been disclosed.<sup>75</sup>

Other industry officials have expressed similar concerns. One large investment consulting firm has stated that many of its plan sponsor clients may not be aware that their investment options utilize securities lending programs. An industry expert we spoke to, who is also a 401(k) plan sponsor, admitted that he did not know whether the investment options offered through his plan engaged in securities lending. Another industry expert told us that there were poor communications between investment option managers and lending agents (e.g., custodial banks)—investment option managers did not ask the right questions about how the cash collateral was being invested, and custodian banks who acted on behalf of investment options’ managers thought their customers were educated enough to understand that the cash collateral posted by borrowers was invested in collective investment pools.

Recent litigation involving banks that engage plan assets in their securities lending programs illustrates instances where plan sponsors may not have understood the practice of securities lending, and where parties involved, under minimal scrutiny, may have taken additional risks with plans’ assets. Over the past few years, plan sponsors and others filed lawsuits against Northern Trust, State Street, JP Morgan, Bank of New York Mellon, Wells Fargo, U.S. Bank, and Wachovia for allegedly violating their fiduciary, contractual, and other legal responsibilities in losing millions of dollars for the investment funds in their securities lending contracts. Most of the lawsuits involve the loss of cash collateral invested by the custodian banks in their securities lending programs. Plan sponsors allege that they were

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<sup>75</sup>Our poll respondents’ responses cannot be considered representative of the overall population of 401(k) plan sponsors. Because of the methodological limitations of this poll, this information is anecdotal and represents only the views of the 74 members who responded to our poll.

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intentionally misled by their custodian banks as to where their cash collateral was being invested. Critics of these plaintiff's lawsuits say that the plan sponsors are simply disgruntled customers seeking to recoup unavoidable investment losses from banks that have profited from their plans' assets.<sup>76</sup>

One way industry experts have suggested to help protect participants' 401(k) retirement savings when placed in investments that utilize securities lending with cash collateral reinvestment is by limiting the percentage of 401(k) plan assets that could potentially be loaned out at any one time. Industry experts we talked to stressed the importance of limiting the amount of 401(k) assets that can be subject to securities lending, similar to SEC staff's limits on lending by mutual funds. SEC staff no-action letters effectively limit the amount of assets that can be lent from a mutual fund at one time to one-third of the fund's total asset value. Furthermore, SEC limits the amount of total mutual fund assets and money market fund assets to 15 percent and 5 percent, respectively, that can be invested in illiquid securities, such as some asset-backed securities that do not trade on exchanges and do not have an accessible market for buyers and sellers.<sup>77</sup> However, there are no comparable limitations on the total amount of 401(k) plan assets that can be lent or invested in illiquid securities.

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<sup>76</sup>We have not verified the status of any of these cases.

<sup>77</sup>The term "illiquid security" generally includes any security that cannot be sold or disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within 7 days.

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## SEC and Others Are Taking Steps to Improve Transparency and Disclosures on Securities Lending, and Labor Can Also Require Better Disclosures for Plan Sponsors

SEC and others in industry are already taking steps to address certain issues related to securities lending. SEC and the Financial Industry Regulatory Authority (FINRA)<sup>78</sup> are working on proposals for additional disclosure on securities lending. The Dodd-Frank Act calls for the SEC to promulgate rules no later than July 21, 2012, that are designed to increase the transparency of information available to brokers, dealers, and investors with respect to the loan or borrowing of securities.<sup>79</sup> FINRA is also looking at promulgating rules that will ensure that broker-dealers allow customers to fully understand all the risks involved and that will focus on disclosing things from potential conflicts to restrictions firms may have on liquidating securities.<sup>80</sup>

It is unclear whether the improved disclosures will provide information about the gains and losses from securities lending to investors and other stakeholders. Currently, banking regulators do not require banks to report gains or losses from their securities lending programs. Although the Financial Accounting Standards Board requires banks to make publicly available this information in their financial statements, the information is not reported to any federal regulator and is also not broken out by type of plan. The Federal Financial Institutions Examination Council<sup>81</sup> supervisory policy on securities lending stipulates that information on securities borrowing and lending transactions should be made publicly available by commercial banks in their financial statements. However, banks do not break out this information by type of plan and may only provide the information as a summary total that includes other revenue streams, such

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<sup>78</sup>FINRA is the largest independent regulator for all securities firms doing business in the United States. It oversees nearly 4,600 brokerage firms, 163,000 branch offices, and 631,000 registered securities representatives. Its chief role is to protect investors by maintaining the fairness of the U.S. capital markets.

<sup>79</sup>Section 984(b) of Dodd-Frank, 15 U.S.C. § 78j. The new act does not limit the authority of the federal banking agencies to also prescribe rules regarding the loan or borrowing of securities.

<sup>80</sup>FINRA has also asked for input on how to create an ADV-like form for broker-dealers, which is the key disclosure document used by investment advisers that requires detailed disclosures of services, conflicts, and fees.

<sup>81</sup>The council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by FRB, FDIC, the National Credit Union Administration, OCC, and the Office of Thrift Supervision, and to make recommendations to promote uniformity in the supervision of financial institutions.

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as investment advisory and administration fees, making it difficult to determine revenue specific to securities lending.

Some securities lending agents have already begun to implement various changes to their securities lending programs and the way they manage cash collateral. These changes have come as a result of securities lending agents, who have recently reported that some plan sponsors that they service have not only requested more disclosure about securities lending and cash collateral pools but have also requested that their securities lending programs take on less risk. For example, one securities lending agent is calling for a “back to basics approach” with the focus on protecting principal and maintaining liquidity while generating incremental returns for participants. Securities lending agents stated that going forward, cash collateral pools would likely be of shorter duration and have more standardized guidelines of what they could invest in. They also said that these guidelines could possibly be structured along the lines of SEC’s liquidity requirements for money market funds, under which, among other things, money market funds must maintain minimum daily and weekly asset positions.<sup>82</sup> With these changes, they believe that 401(k) plan participants could receive some protection from the losses and withdrawal restrictions that they recently experienced.

Labor could also take steps to improve transparency on the practice of securities lending by amending its prohibited transaction exemption regarding the practice of securities lending. Labor’s PTE 2006-16, authorizes securities lending transactions that might otherwise constitute “prohibited transactions” under ERISA, but the exemption currently lacks specifics on the utilization of 401(k) plan assets in the practice of securities lending. In addition, according to Labor, the exemption does not address or provide any relief for the reinvestment of cash collateral.<sup>83</sup>

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<sup>82</sup>SEC’s rule 2a-7, which governs money market funds, requires that all taxable money market funds maintain at least 10 percent of their assets in cash, U.S. Treasury securities, or securities that mature or can be converted to cash within one business day, and that all money market funds hold at least 30 percent of their assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that mature or can be converted to cash within a week.

<sup>83</sup>Labor’s PTE 2006-16 does state, however, that, in return for lending securities, the plan may receive a reasonable fee (in connection with the securities lending transaction) and/or have the opportunity to earn additional compensation through the investment of cash collateral. It further states that all fees and other consideration received by the plan in connection with the loan of securities should be reasonable.

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Without such information, plan sponsors do not have the information they need to assess the potential gains and losses from cash collateral reinvestments, since other regulators that oversee the financial entities involved in securities lending also do not require that such information be explicitly disclosed to plan sponsors. By revising the existing exemption, Labor can ensure that plan sponsors who enter into securities lending arrangements with cash collateral reinvestment are not prevented from meeting their fiduciary obligations when doing so.

Labor can also help to ensure that plan sponsors clearly understand the gains and losses associated with securities lending by amending its two recently issued rules, one regarding service provider disclosure to plan sponsors,<sup>84</sup> and one regarding plan sponsor disclosure to participants, to include information specific to securities lending. The recent amendment to the interim final rule, which affects the “up-front” or “point of sale” disclosure, i.e., when a service provider and a plan sponsor enter into a service agreement or contract, enhances disclosure to fiduciaries of 401(k) and other retirement plans. It requires service providers to disclose, among other things, a description of the services to be provided; a statement that the covered service provider will provide its services as a fiduciary to the covered plan;<sup>85</sup> a description of all “direct compensation” (i.e., compensation received directly from the covered plan) and “indirect compensation” (i.e., compensation that is received from any source other than the covered plan, plan sponsor, covered service provider, an affiliate, or a subcontractor) that the covered service provider reasonably expects to receive in connection with the disclosed services. The regulation is meant to assist fiduciaries in determining both the reasonableness of compensation paid to plan service providers and any conflicts of interest that may impact a service provider’s performance under a service contract or arrangement.

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<sup>84</sup>Reasonable Contract or Arrangement Under Section 408(b)(2)–Fee Disclosure; Interim Final Rule, 75 Fed. Reg. 41,600 (July 16, 2010)(to be codified at 29 C.F.R. § 2550.408b-2).

<sup>85</sup> A statement is also required when the covered service provider provides their services as a registered investment advisor. A “covered service provider” is a provider that enters into a contract or arrangement with the retirement plan and expects to receive \$1,000 or more in direct or indirect compensation for services to the plan, regardless of whether the services are performed by the covered service provider, an affiliate, or a subcontractor, or as a registered investment advisor registered under the Advisors Act or under state law providing services directly to the plan.

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With regard to the practice of securities lending, the regulation would presumably require a custodian to disclose the fact that it receives compensation from its role in the investment strategy of securities lending. However, it is unclear how much assistance it would provide to plan sponsors in understanding securities lending with cash collateral reinvestment or the gains and losses associated with that practice. For example, as currently written, it is unclear whether it would be obvious to the plan sponsor how much of a profit the custodian would take compared with the profit the plan would receive. It is also unclear whether the custodian would have to reveal exactly how it used the plan's profit, such as to reduce plan fees, or whether the custodian would disclose that the other service providers involved in the transaction received their compensation, in the form of fees and rebates, regardless of the performance of the cash collateral reinvestment pool. Labor's regulations, as currently written, will not assist plan sponsors in understanding the mechanics of a securities lending transaction and how the entities involved in the transaction, specifically those involved in the cash collateral reinvestment activity, are paid. Plan sponsors need to know that the profit they make is a net return after everyone else is paid for their role and that any loss from the cash collateral pool comes out of their plans' assets. The current regulations also do not contain specific provisions requiring disclosure of the potential for withdrawal restrictions, which could assist plan sponsors in their decision-making process when selecting investment options to offer through their 401(k) plans.

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## Conclusions

For a growing number of American workers, their prospects for a secure retirement increasingly rest on the retirement savings they accumulate in their 401(k) plans. One of the touted benefits of 401(k) plans was their transparency to and control by participants. Participants could see their accounts grow and control how much to contribute and where to invest those contributions. Yet, it is becoming increasingly obvious that saving for retirement is not as simple as it appeared 30 years ago when 401(k) plans were first created. As this report shows, and as our past report on undisclosed fees and more recent reports on target date funds and conflicted investment advice illustrate, managing the risks faced in savings for retirement through 401(k) plans today can be complicated and pose significant challenges for participants and sponsors alike.

At a minimum, greater transparency and disclosure are necessary to help plan sponsors and participants understand the restrictions and limitations they could face with certain 401(k) investment options and the risk of loss to plan participants' investments in 401(k) plans. The recent financial

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crisis vividly illustrated the importance of transparency when dealing with complex financial instruments. What seems like an optimal way to make money off of 401(k) plan assets, such as through securities lending with cash collateral reinvestment, can appear to be straightforward until the scope of the risks and complexities of the cash collateral reinvestment transaction have to be explained to investors, plans sponsors, and plan participants. Expecting plan sponsors and plan participants to understand the intricacies of today's many investment options without sufficient guidance and information is unrealistic.

Without more explicit and accessible information on stable value funds and securities lending with cash collateral reinvestment, participants are unknowingly bearing a greater risk of loss than they are currently aware of and, more importantly, have no control over. Labor has already provided much needed disclosure requirements for plan sponsors to give to plan participants. Amending those regulations to include disclosure explicitly targeted to the risks of investing in stable value funds and provisions on securities lending will help to ensure that plan participants, like plan sponsors, are informed about stable value funds and securities lending with cash collateral reinvestment and are able to make the best decisions to save for their retirement.

The maturation of the 401(k) system, coupled with the increased complexity of the financial markets, is posing new challenges for Labor, financial regulators, plan sponsors, and participants. Changes called for in the Dodd-Frank Act are likely to clarify stable value contracts and provide more disclosure on securities lending. Because of the statutory requirements in the Dodd-Frank Act, Labor has an opportunity to assist plan sponsors and participants with two complex areas, stable value fund contracts and securities lending with cash collateral reinvestment. Such careful, thoughtful action to facilitate prudent decision making on the part of sponsors and participants can bolster retirement security and avoid the long-term loss of participant confidence in the 401(k) system.

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## Recommendations For Executive Action

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act includes requirements that will affect deliberations about stable value funds and requires that the SEC and the CFTC, in consultation with Labor and Treasury, conduct a study of stable value funds. To ensure additional protection for plan participants, appropriate information for plan sponsors, and to better inform the study required by the Dodd-Frank Act, we recommend that Labor take the following actions:



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- As it conducts its consultative analysis to assist the SEC and CFTC, also analyze stable value funds specifically in a 401(k) investment context to identify those situations or conditions that prevented plan sponsors from withdrawing from stable value funds, such as contract restrictions, and take appropriate regulatory steps to assist plan sponsors in fulfilling their fiduciary responsibilities.
  - Amend its regulation on plan sponsor disclosure to participants to include a specific requirement for plan sponsors to provide information to participants that discloses the risks of investing in stable value funds.
  - Provide guidance to plan sponsors on the risks, structure, and dynamics of stable value funds, consistent with the recommendations proposed by the ERISA Advisory Council regarding the disclosure of information about stable value funds.

Given the current practice of securities lending with cash collateral reinvestment, its role in 401(k) plan investments, and our findings that plans and plan participants can bear a disproportionate amount of any loss associated with the practice, Labor should take action to help plan sponsors of 401(k) plans and plan participants understand the role, risk, and benefits of securities lending with cash collateral reinvestment in relation to 401(k) plan investments. ERISA requires that the fees paid to plan service providers be reasonable with respect to the services performed and Labor, in its implementation of PTE 2006-16, its prohibited transaction class exemption for securities lending, specifically requires that compensation received by the parties involved in the securities lending transaction should be reasonable. According to Labor, PTE 2006-16 does not cover cash collateral reinvestment. Therefore, we recommend that Labor also take the following actions:

- Review the practice of securities lending with cash collateral reinvestment, to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) plan assets are utilized in this practice.
- Revise PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements utilizing cash collateral reinvestment on behalf of 401(k) plan participants not do so unless they ensure the reasonableness of the distributions of expected returns associated with this arrangement.
- Amend its regulation on plan sponsor disclosure to participants to include provisions specific to (1) the practice of cash collateral reinvestment

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utilized by fund providers' securities lending programs and (2) disclosing the potential for withdrawal restrictions.

- Provide plan sponsors with guidance alerting them to the risks of engaging in securities lending with cash collateral reinvestment and the types of information they should seek from their service providers about these investments.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Department of Labor, the Securities and Exchange Commission, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation for review and comment. Labor's formal comments are reproduced in appendix I of this report. We did not receive formal comments from the Securities and Exchange Commission, the Federal Reserve Board, the Office of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation, but received technical comments from four of the five agencies, which we incorporated as appropriate.

In its agency response letter, the Department of Labor agreed with our conclusions concerning the importance of transparency and disclosure. Consistent with our conclusions, Labor noted that it is committed to ensuring that participants have the information they need to make informed decisions about their retirement savings and that plan sponsors receive the information they need to assess the reasonableness of contracts or arrangements. Labor also noted that it has recently devoted significant resources to ensure that plan sponsors and participants have the information they need. Labor has agreed to consider amending PTE 2006-16 to require the securities lending agreement to provide enhanced disclosures to plan fiduciaries and to consider providing plan sponsors with guidance alerting them to the risks of engaging in securities lending and the types of information they should seek from their service providers about these investments. Labor disagreed with three of our recommendations.

Labor disagreed with our recommendation to amend its participant disclosure regulations to provide information disclosing the risks of investing in stable value funds. It stated that without further study and review, the department is not prepared to conclude that its participant disclosure regulations should be amended to specifically address stable value funds. Given the complexity of the issues involving stable value funds, we encourage Labor to initiate the study, review what it deems necessary, and to amend its disclosure regulations as appropriate. We note

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Labor's additional consideration to the recommendations proposed by the ERISA Advisory Council regarding information provided to plan sponsors and participants concerning stable value funds, and we believe that plan sponsors and participants would benefit from such guidance being issued in a prudent but expeditious manner. Given that the ERISA Advisory Council report on stable value funds was posted in April 2010, without additional guidance or assistance, plan sponsors may remain unaware of the risks and challenges associated with this investment option. Furthermore, because Labor will be consulting with SEC and CFTC with regard to their study of stable value funds, Labor has a unique opportunity to assist participants in their understanding of the restrictions, limitations, and risks of investing in such funds. We look forward to the findings, conclusions and proposed actions of Labor's consultation and believe that this effort represents a great opportunity for Labor to assist plan sponsors and participants in building retirement security.

Labor disagreed with our recommendation to amend its participant disclosure regulations regarding the practice of securities lending with cash collateral reinvestment and the potential for withdrawal restrictions. The Department stated that without further study and review, it is not prepared to conclude that its participant disclosure regulations should be amended to specifically address securities lending-related issues. While we believe that the evidence provided in our report is particularly compelling with regard to this recommendation, we strongly encourage Labor to initiate the study and review what it deems necessary, and, to amend its disclosure regulations as appropriate. As demonstrated in our report, securities lending with cash collateral reinvestment arrangements can be very complex transactions. Further, as we reported, Labor's participant disclosure regulations do not explicitly require plan sponsors to disclose information on the risks of securities lending with cash collateral reinvestment or withdrawal restrictions that can result from securities lending. We acknowledge Labor's comment that the current participant disclosure regulations require that information pertaining to investment risks and investment strategies be available to plan participants. However, as we reported, these regulations require only disclosure of investment options, and not all practices utilized by those investment options—of which securities lending is one practice—and it is unclear how much or to what extent securities lending fees and risks will be discussed in these disclosures. Furthermore, Labor only requires that information be made available to plan participants, not disclosed, which would require plan participants to know what information they need to avail themselves of in order to understand the fees and risks of securities lending. Without better disclosures on securities lending with cash collateral, participants

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may continue to be unaware of the practice of cash collateral reinvestment and the risks it poses, as well as the potential for withdrawal restrictions resulting from such practices.

Labor also did not agree with our recommendation to review the practice of securities lending with cash collateral reinvestment to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) assets are utilized in this practice. Labor noted that a plan sponsor, in deciding to offer any investment option, must make that decision in accordance with its fiduciary responsibility under ERISA, and that it would not be possible for Labor to provide specific guidance on reasonable levels of fees and reasonable distributions of returns in connection with any particular securities lending cash collateral reinvestment. We recognize the complexity of these transactions and the diligence that should be taken in developing such guidance. Nevertheless, key participants in securities lending transactions are already moving in the direction of providing additional guidance to plan sponsors. For example, as we reported, some securities lending agents have already begun to make changes to their securities lending programs in response to plan sponsors who have requested more disclosure about securities lending and cash collateral pools and have also requested that their securities lending programs take on less risk. In addition, securities lending agents are beginning to standardize guidelines for cash collateral pool investments, changes which they think would provide participants with some protection from losses. These industry driven developments clearly suggest that not only is such guidance possible, but that it is in the best interest of plan sponsors for Labor to provide some assistance on this issue.

Finally, Labor disagreed with our recommendation regarding the inclusion of cash collateral reinvestment into PTE 2006-16, regarding the reasonableness of expected returns associated with this arrangement. Labor believes that it is not feasible to ensure a certain level of expected return on any particular investment. It is not our intent that rates of return should be ensured in such transactions, but that the reasonableness of the distributions of expected returns be ensured. We note, however, that under ERISA, Labor is already responsible for enforcing the requirements that plan sponsors ensure that the fees paid with plan assets are reasonable and for necessary services. Applying the same standard to the parameters of transactions involving securities lending with cash collateral can help reduce the risk of loss to plan participants. As we note in our report, securities lenders are already implementing changes that could redefine the potential of loss and return to plan participants from these

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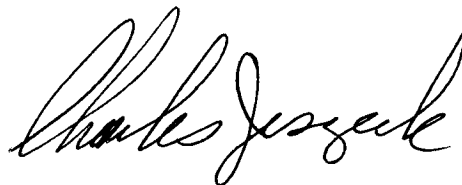
transactions. Action by Labor can help to ensure that it will not only be sophisticated plan sponsors who are likely to get the disclosures they need, while other plans sponsors continue to be unaware of what they need to ask for and understand regarding securities lending with cash collateral reinvestment.

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As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 6 days from the report date. At that time, we will send copies of this report to the appropriate congressional committees, the Secretary of Labor, the Chairman of the Securities and Exchange Commission, and other interested parties. The report also will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff members have any questions concerning this report, please contact Charles Jeszeck at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Charles Jeszeck". The signature is fluid and cursive, with the first name "Charles" being more prominent than the last name "Jeszeck".

Charles A. Jeszeck  
Director, Education, Workforce,  
and Income Security Issues

# Appendix I: Comments from the Department of Labor

**U.S. Department of Labor**

Assistant Secretary for  
Employee Benefits Security Administration  
Washington, D.C. 20210



February 25, 2011

Mr. Charles A. Jeszeck  
Director, Education, Workforce, and  
Income Security Issues  
United States Government Accountability Office  
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "401(k) PLANS: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood" (GAO-11-291). Based on our review of the report, below are our comments and observations.

The draft report finds that during the recent financial crisis, plan sponsors and participants faced unexpected restrictions on withdrawals of plan assets from certain 401(k) investment options, specifically real estate accounts, money market funds, stable value funds and investment options that lend securities. It concludes, among other things, that greater transparency and disclosure are necessary to assist plan sponsors and plan participants in understanding restrictions, limitations, and risk of loss to plan participants associated with investment in stable value funds and investment options that lend securities.

In this regard, the Department has recently devoted significant resources to ensuring that all participants and beneficiaries in participant-directed individual account plans (e.g., 401(k) plans) have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings, and to ensuring that plan fiduciaries receive disclosures from service providers to assist the fiduciaries in assessing the reasonableness of contracts or arrangements, including the reasonableness of the service providers' compensation and potential conflicts of interest that may affect the service providers' performance.<sup>1</sup>

<sup>1</sup> See Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans; Final Rule, 75 FR 64910 (October 20, 2010); Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure; Interim Final Rule, 75 FR 41600 (July 16, 2010).

**Recommendation 1: The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act includes requirements that will affect deliberations about stable value funds and requires that the SEC and CFTC, in consultation with Labor and Treasury, conduct a study of stable value funds. To ensure additional protection for plan participants, appropriate information for plan sponsors, and to better inform the study required by the Dodd-Frank Act, we recommend that Labor:**

- **As it conducts its consultative analysis to assist the Securities and Exchange Commission and the Commodity Futures Trading Commission, also analyze stable value funds specifically in a 401(k) investment context to identify those situations or conditions that prevented plan sponsors from withdrawing from stable value funds, such as contract restrictions, and take appropriate regulatory steps to assist plan sponsors in fulfilling their fiduciary responsibilities.**

The Department will consider whether further action would be appropriate after consulting with the SEC and the CFTC upon completion of their study as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

- **Amend its regulation on plan sponsor disclosure to participants to include a specific requirement for plan sponsors to provide information to participants that discloses the risks of investing in stable value funds.**

The Department disagrees with this recommendation. Without further study and review, the Department is not prepared to conclude that the regulations governing the disclosure of investment-related information to participants and beneficiaries must be amended to specifically address stable value funds. The current regulation specifically requires that information pertaining to investment risks, as well as investment strategies, be available to plan participants with respect to all investment alternatives offered under a participant-directed individual account plan, including stable value funds.

- **Provide guidance to plan sponsors on the risks, structure, and dynamics of stable value funds, consistent with the recommendations proposed by the ERISA Advisory Council regarding the disclosure of information about stable value funds.**

While the Department is not prepared at this time to commit to providing the recommended guidance, the Department will pursue further consideration of the recommendations prepared by the ERISA Advisory Council regarding stable value funds.

**Recommendation 2: Given the current practice of securities lending with cash collateral reinvestment, its role in 401(k) plan investments, and our findings that plans and plan participants can bear a disproportionate amount of any loss associated with the practice, Labor should take action to help plan sponsors of 401(k) plans and plan participants understand the role, risk, and benefits of securities lending with cash collateral reinvestment in relation to 401(k) investments. ERISA requires that the fees paid to the plan service providers be reasonable with respect to the services performed and Labor, in its implementation of PTE 2006-16, its prohibited transaction class exemption for securities lending, specifically requires that compensation received by the parties involved in the securities lending transaction should be reasonable. According to Labor, PTE 2006-16 does not cover cash collateral reinvestment. Therefore we recommend Labor:**

- **Review the practice of securities lending with cash collateral reinvestment, to provide guidance to plan sponsors as to what would be reasonable levels of fees and reasonable distributions of returns when 401(k) plan assets are utilized in this practice.**

The Department disagrees with this recommendation. The Department notes that a plan sponsor's decision to offer any investment option, which may engage in securities lending, is a decision that must be made in accordance with the fiduciary responsibility provisions of ERISA, based on all relevant facts and circumstances. Because each decision is made based on a number of variables, it would not be possible for the Department to provide specific guidance on reasonable levels of fees and reasonable distributions of returns in connection with any particular securities lending cash collateral reinvestment.

- **Revise PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements utilizing cash collateral reinvestment on behalf of 401(k) plan participants not do so unless they ensure the reasonableness of the expected returns associated with this arrangement.**

A plan sponsor's decision to engage in securities lending is a decision that must be made in accordance with the fiduciary responsibility provisions of ERISA, based on all relevant facts and circumstances. These provisions require, among other things, that a plan receive reasonable compensation for the level of risk associated with the investment. The Department's PTE 2006-16 provides relief from ERISA's prohibited transaction provisions for both the lending of securities by employee benefit plans to banks and broker-dealers and the receipt of compensation by a securities lending fiduciary in connection with services provided to a plan. As currently granted, the exemption does not address or provide relief for the reinvestment of the cash collateral.

Currently, section II(g) of the exemption requires that all fees and other consideration received by the plan in connection with the loan of securities are reasonable. The Department does not believe it is feasible to require additionally that plan sponsors



ensure a certain level of expected return on any particular investment. Market forces and the choice of investments for the cash collateral will impact the return to the plan. However, the Department will consider whether to amend PTE 2006-16 to require the securities lending agreement described therein to provide enhanced disclosures to plan fiduciaries.

- **Amend its regulation on plan sponsor disclosure to participants to include provisions specific to (1) the practice of cash collateral reinvestment utilized by fund providers' securities lending programs and (2) disclosing the potential for withdrawal restrictions.**

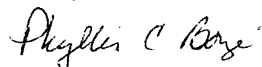
The Department disagrees with this recommendation. Without further study and review, the Department is not prepared to conclude that the regulations governing the disclosure of investment-related information to participants and beneficiaries must be amended to specifically address securities lending-related issues.

- **Provide plan sponsors with guidance alerting them to the risks of engaging in securities lending with cash collateral reinvestment and the types of information they should seek from their service providers about these investments.**

The Department will consider this recommendation in light of its experience with security lending practices.

EBSA is committed to protecting the employer-sponsored benefits of American workers, retirees, and their families. Again, thank you for the opportunity to review the draft report. Please do not hesitate to contact us if you have questions concerning this response or if we can be of further assistance.

Sincerely,



Phyllis C. Borzi  
Assistant Secretary

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Charles Jeszeck, (202) 512-7215, or [jeszeckc@gao.gov](mailto:jeszeckc@gao.gov)

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## Staff Acknowledgments

In addition to the individual named above, the following team members made significant contributions to this report: Tamara Cross, Assistant Director; Monika Gomez, Analyst-in-Charge; Jessica Gray; James Bennett; Susannah Compton; Sheila McCoy; Roger Thomas; and Walter Vance.

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# Glossary

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The terms below are defined for the purposes of this GAO report.

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## Asset-Backed Security

An asset-backed security is a security whose value and income payments are derived from and collateralized (or “backed”) by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

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## Balanced Fund

Balanced funds are pooled accounts invested in stocks, bonds, and often additional asset classes. They are classified into two subcategories: target-date funds and non-target-date balanced funds.

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## Book Value

The book value of a stable value fund is the principal contributed to the investment option, plus accrued interest, minus withdrawals and fees. Accrued interest, minus withdrawals and fees, is calculated based on a methodology specified in the stable value fund contract and is reset on a periodic basis, which is usually quarterly or semiannually.

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## Broker-Dealer

The broker-dealer borrows securities on behalf of its customers, providing cash as collateral to the securities lending agent. A broker-dealer is a company or other organization that trades securities for its own account or on behalf of its customers. Although many broker-dealers are “independent” firms solely involved in broker-dealer services, many others are business units or subsidiaries of commercial banks, investment banks or investment companies. When executing trade orders on behalf of a customer, the institution is said to be acting as a broker. When executing trades for its own account, the institution is said to be acting as a dealer.

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## Cash Collateral Pool Manager

The cash collateral pool manager invests the cash provided as collateral for the borrowed securities in order to earn additional return for the securities lending agent during the period of time that the securities are borrowed. The securities lending agent can be the cash collateral pool manager, but usually it is an affiliate of the securities lending agent.

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<b>Collateral Deficiency</b>	A situation when the securities lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption.
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<b>Collective Investment Fund</b>	Collective investment funds (CIF) are bank investment trusts that pool the investments of retirement plans or other institutional investors.
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<b>Commingled Fund</b>	Commingled or collective funds are designed to combine the assets of unrelated retirement plans, enabling participants to diversify and gain the economies of scale, i.e., the advantages that being part of a larger fund affords, such as greater profits and less cost.
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<b>Counterparty Risk</b>	The risk to each party of a contract that the counterparty will not live up to its contractual obligations. In a securities lending transaction, this is the risk to the lender that the borrower will fail to return the securities.
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<b>Federal Agency Securities</b>	Federal agency securities are debt instruments issued by federal credit agencies.
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<b>Illiquid Security</b>	The term “illiquid security” generally includes any security which cannot be sold or disposed of promptly and in the ordinary course of business without taking a reduced price. A security is considered illiquid if a fund cannot receive the amount at which it values the instrument within seven days.
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<b>Institutional Investor</b>	An institutional investor is an organization that pools large sums of money and invests those sums in securities, real property and other investment assets. Institutional investors are typically banks, insurance companies, retirement or pension funds, hedge funds, foundations and mutual funds.
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<b>Intrinsic Value</b>	Intrinsic value refers to the return on a securities loan excluding the benefit of active collateral management. It is the spread between the rebate rate and the benchmark rate, e.g. federal funds rate.
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**Market Risk** The potential for portfolio losses resulting from the change in value of stock prices of the portfolio's assets, interest rates, foreign exchange rates, and commodity prices.

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**Market Value** The market value of a stable value fund is the price at which the underlying assets of the fund are trading in the market at a given time.

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**Money Market Funds** Money market funds are open-end management investment companies that are registered under the Investment Company Act of 1940 and regulated under rule 2a-7 under that Act. Money market funds invest in high-quality, short-term debt instruments such as commercial paper, treasury bills and repurchase agreements. Generally, these funds, unlike other investment companies, seek to maintain a stable net asset value per share (market value of assets minus liabilities divided by number of shares outstanding), typically \$1 per share.

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**Mortgage-Backed Securities** Mortgage-backed securities are securities whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying mortgage loans, most commonly on residential property shares of a home loan sold to investors. For example, a bank or other entity lends a borrower the money to buy a house and collects monthly payments on the loan. This loan and a number of others, perhaps hundreds, are sold to a larger bank that packages the loans together into a mortgage-backed security. The larger bank then issues shares of this security to investors who buy them and ultimately collect the dividends in the form of the monthly mortgage payments.

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**Mutual Fund** A mutual fund, legally known as an open-end investment company, is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. These investments comprise the fund's portfolio. Mutual funds are registered and regulated under the Investment Company Act of 1940, and are supervised by the SEC. Mutual funds sell shares to public investors. Each share represents an investor's proportionate ownership in the fund's holdings and the income those holdings generate. Mutual fund shares are "redeemable," which means that when mutual fund investors want to sell their shares, the investors sell them back to the fund, or to a broker acting for the fund,

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at their current net asset value per share, minus any fees the fund may charge.

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**Participant-Directed  
401(k) Plan**

A 401(k) plan that generally allows a participant to choose how much to invest, within federal limits, and to select from a menu of diversified investment options chosen by the plan sponsor.

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**Nontarget-Date Balanced  
Funds**

Nontarget-date balanced funds include asset allocation or hybrid funds.

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**Plan Participants**

Plan participants contribute to their 401(k) and direct that contribution to certain investment options. In 401(k) plans the assets are held in trust for participants.

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**Plan Sponsor**

A plan sponsor chooses which investment options to offer to its participants, and when making that choice, decides on whether to offer investments that engage in securities lending.

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**Plan Service Provider**

A plan service provider purchases securities on behalf of 401(k) plan participants. A plan service provider may act as securities lending agent.

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**Private Placements**

A private placement is a direct offering of securities directly to an institutional investor, such as a bank, mutual fund, insurance company, pension fund, or foundation.

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**Prohibited Transaction**

Prohibited transactions under ERISA include a sale, exchange, or lease between a plan and a party-in-interest; lending money or other extension of credit between the plan and party-in-interest; and furnishing goods, services, or facilities between the plan and party-in-interest, among other prohibited transactions.

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**Real Estate Accounts**

Real estate accounts are open-ended, commingled accounts that invest directly in real estate, such as funds that buy and manage commercial properties. Real estate accounts are equity accounts consisting primarily of high quality, well-leased real estate properties in the industrial, office, retail and hotel sectors. Real estate accounts may be offered by insurance

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companies as separate accounts, and are regulated by the state insurance commissioner in the state they are created.

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**Rebate**

A payment to the broker-dealer, as they would have earned a short-term rate of return on the cash they provided as collateral if they had kept it in their possession. The greater the demand for the security being lent, the lower the rebate paid to the broker-dealer by the securities lending agent. Securities that have an extremely high borrowing demand, or that are in short supply and therefore hard to borrow, can obtain “negative” rebates, requiring the borrower to not only pledge cash, but also pay a fee to plan participants.

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**Securities Lending**

The lending of some of the assets held in investment options, on behalf of plan participants, to third parties, usually broker-dealers, for a period of time. In return, broker-dealers provide collateral to securities lending agents that they hold until broker-dealers return the borrowed securities. Collateral for the loan can be either cash or securities, such as bonds or stocks. If securities lending agents accept securities as collateral for the loan, broker-dealers will typically pay a fee to borrow the securities. However, in the U.S., cash is the primary form of collateral taken in securities lending transactions and if cash is taken as collateral, the securities lending agent does not receive a fee, but, instead, has the right to reinvest the cash to earn an additional return. This is sometimes called “cash collateral reinvestment,” and is typically considered a separate, but related, activity to the securities lending transaction.

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**Securities Lending Agent**

The securities lending agent coordinates loans of securities, hires a manager to invest cash collateral and may take on counterparty risk—or the risk that the borrower will not return the securities—on behalf of the plan. May be an affiliate of the custodian, i.e., an entity, usually a bank, that has legal responsibility for safekeeping a plan’s securities.

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**Separate account GICs**

Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return, which may be fixed, indexed, or reset periodically based on the actual performance of the underlying assets. The insurance company owns and holds the underlying assets in a separate, customized account for the exclusive benefit of a single plan.

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<b>Stable Value Fund</b>	Stable value funds are a fixed income investment option, designed to preserve the total amount of participants' contributions, or their principal, while also providing steady, positive returns set in the contract.
<b>Statement of Additional Information</b>	A Statement of Additional Information (SAI) is a supplementary document to a mutual fund's prospectus that contains additional information about the mutual fund and includes further disclosure regarding its operations.
<b>Synthetic Guaranteed Investment Contracts</b>	Plan sponsors contract with a bank or insurance company to guarantee participants principal protection and a rate of return relative to a portfolio of assets held in an external trust owned by the plan. The rate of return, which is based on the actual performance of the underlying assets, is reset periodically.
<b>Target Date Funds</b>	Target date funds are often mutual funds and hold a mix of stocks, bonds, and other investments. Over time, the investment allocation gradually shifts according to the fund's investment strategy. Target date funds are designed to be investments for individuals with particular retirement dates in mind.
<b>Traditional Guaranteed Investment Contracts</b>	Plan sponsors contract with an insurance company to guarantee participants principal protection and a rate of return regardless of the performance of the underlying assets, which the insurance company owns and holds within their general account.
<b>Trustee-Directed 401(k) Plan</b>	A 401(k) plan wherein an employer appoints trustees who decide how the plan's assets will be invested.



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