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Beyond ERISA: Other Regulatory Considerations for State-Sponsored Retirement Plans

By David Morse

The U.S. Department of Labor (DOL) recently issued a proposed rule to create a safe harbor allowing states to establish mandatory workplace-based IRA savings programs which are exempt from ERISA (Employee Retirement Income Security Act). These "Secure Choice" programs will allow otherwise uncovered workers a simple, low-cost and effective way to save through payroll withholding into state-sponsored IRAs.

The ERISA exemption was crucial to allowing states to require that certain employers offer the program and to auto-enroll their employees. Auto-enrollment is a very effective tool for helping workers save for retirement. The DOL is expected to finalize the proposed rule before the end of the year and perhaps as early as this summer.

While DOL has taken steps to resolve the uncertainty of ERISA's applicability to these state-sponsored retirement programs, states, as part of their due diligence, are also examining the other federal regulations, most notably those raised by federal securities laws and the Patriot Act, which should be considered in designing their programs. These laws can be overlooked because they rarely impact the operation of 401(k) and other savings plans; however, the law treats IRAs and 401(k)s differently.

While it is important that states be aware of these other rules, states should continue to move forward to help more workers save for their retirement. States can work closely with federal regulators to constructively resolve issues and preserve important consumer protections, while designing programs that will allow workers to benefit from a wider array of savings options.

Federal Securities Law: Two Basic Questions

A primary aim of securities laws is to protect investors — particularly small "retail" investors — by requiring, among other things, full and fair disclosure of information on investments, fees, advisers and the like. While a number of federal securities laws could be relevant to Secure Choice, two key statutes are the Investment Company Act of 1940 (40 Act) and the Securities Act of 1933 (33 Act). The 40 Act regulates mutual

funds and other “investment companies.” The 33 Act regulates the offer and sale of “securities,” defined broadly as ordinary stocks and bonds and also mutual fund shares and certain “investment contracts.”

Federal securities laws raise two basic questions: are state-sponsored Secure Choice programs *themselves* exempt; and can a state retirement savings program offer the type of investments available to 401(k) and other savings plans but not regular IRAs? The answers to both questions should be yes.

Question 1: Are State or Other Government Plans Exempt?

Federal securities laws generally exempt states and their agencies or instrumentalities (state instrumentalities) from regulation as investment companies under the 40 Act and any securities issued by a state instrumentality are similarly exempt from registration under the 33 Act. If state-sponsored retirement plans for private sector workers are viewed as state instrumentalities, it follows logically that a Secure Choice program should be exempt from federal securities law regulation. This makes perfect sense both legally (the programs are created by state law, intended to benefit state citizens and operated under state supervision) and as a policy matter because program participants will be well-protected by state boards and trustees, who will in turn be advised by a team of experts. In fact, Secure Choice participants would not be your typical IRA owners in the market place because the state boards and their advisers will be vetting and monitoring service providers and products.

The pre-paid college tuition savings programs — or “529 savings programs” — states began establishing more than twenty years ago are good examples of state-run programs treated as state instrumentalities for securities law purposes. Most 529 programs include state-established investments for program participants. The SEC staff issued several no-action letters confirming that these arrangements were exempt from federal securities law regulation under the exemptions for state instrumentalities. By taking such action, the SEC staff interpreted the term state instrumentality to include the concept of prepaid tuition programs being offered and sold to the general public (students and their families). Once a state-sponsored and managed program is viewed as an instrumentality of the state, it fits logically within the pertinent securities laws exemptions.

Question 2: Can State Retirement Plans for Private Sector Workers Offer the Same Types of Investments as 401(k) and Other Defined Contribution Plans?

If Secure Choice programs themselves are exempt, what about their underlying investments? Because the typical IRA owner is a retail investor, he/she is generally restricted to 40 Act registered mutual funds and certain registered insurance company

annuity products; with limited exceptions, IRAs are not eligible to invest in unregistered pooled funds and other privately offered vehicles. The difference is not merely semantic. While functionally similar to "retail" mutual funds, unregistered funds enjoy more regulatory freedom and correspondingly lower expenses and afford sponsors flexibility to create "private label" investments customized to participants. A state not wishing to offer only registered mutual funds in its program has two choices. First, it could establish and register its own bespoke mutual funds. However, the registration process with its attendant disclosure, paperwork, and audit requirements could drive-up expenses, without offsetting benefits to program participants. Another, more attractive, choice is to create — with the assistance of experienced financial firms — private label investment accounts *within and exclusively for* a state Secure Choice program. These accounts could be customized to program participants and offer advantages similar to those available to 401(k) and 457 plans investing in unregistered vehicles.

State boards preferring private label investment options can point to a favorable distinction between, on the one hand, traditional IRAs, which typically are owned and managed by individuals acting for themselves and, on the other hand, employer-sponsored 401(k) and similar employee savings programs. The securities laws generally take a "hands off" approach to employer-sponsored plans because employer sponsors (as well as plan trustees and investment professionals retained by the employer) are on the front lines protecting the individual plan participants. Similarly, Secure Choice participants will have state-appointed boards, trustees, custodians, professional managers and advisors to protect their interests. Thus, Secure Choice IRAs will not need or be helped by the securities regulations intended to protect a regular retail IRA investor. Financial firms sponsoring unregistered investment vehicles for 401(k) plans can assist boards in developing low-cost private label programs tailored to Secure Choice program participants, furthering the overall mission of helping workers save for their own retirement.

Patriot Act Requirements: Plan Accordingly

The Patriot Act requires record keepers, trustees, and others to "know their customers" before setting up an account. That means having a full name, address, date of birth and a Social Security number that match and do not raise any red flags. When opening an IRA, the individual directly supplies the needed information to the vendor but for a 401(k), the employer supplies the information. The 401(k) approach should work equally as well for Secure Choice, with any discrepancies being resolved by the participant dealing directly with the record keeper and without employer involvement. Withholding would not start until the problem is resolved. States should make the handling of the Patriot Act part of the requirements for record keepers and make sure to incorporate this need into any competitive bids, so potential vendors clearly understand and can deliver what is expected.

The Regulatory Path Forward

ERISA is not the only regulatory consideration for state-enabled retirement programs for private sector workers. The SEC staff has been receptive to applying the state instrumentality exemptions to other novel state programs created to help fill a pressing need, such as college 529 savings programs, so there is reason for optimism for state-sponsored retirement savings programs. States therefore should continue to move forward to help more workers save for their retirement. History suggests that federal-state collaboration can produce better outcomes. States can work closely with federal regulators to constructively resolve issues, preserve important consumer protections, while allowing workers to benefit from a wider array of savings options.

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