WRITTEN STATEMENT
OF THE HONORABLE RAY GARRETT, JR., CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION,
In Support Of Proposed Exemptions From Prohibitions On Transactions Between Employee Benefit Plans And Certain Broker-Dealers, Pursuant To Section 4975(C)(2) Of The Internal Revenue Code Of 1954 And Section 408(A) Of The Employee Retirement Income Security Act Of 1974

January 21, 1975

On January 10, 1975, the Department of the Treasury (Internal Revenue Service) and the Department of Labor announced a proceeding under Section 4975(c)(2) of the Internal Revenue Code of 1954 and Section 408(a) of the Employee Retirement Income Security Act of 1974[1] ("ERISA") or ("the Act") to consider temporary exemptions for certain transactions between employee benefit plans and certain broker-dealers. The Securities and Exchange Commission is pleased to have the opportunity to present its views on the need for the exemptions proposed.[2]

In recent weeks, much concern and uncertainty has been expressed by persons affected by ERISA, and their counsel, as to the appropriate construction of various provisions of the Act, particularly those provisions applicable to customary and ordinary transactions between employee benefit plans and broker-dealers. As a result, numerous persons engaged in the business of effecting transactions in securities with or on behalf of employee benefit plans have been advised by counsel to curtail their dealings with

plans, pending clarification of the provisions of the Act in question or appropriate exemptive relief.

In the Commission's view, this could have an unintended, and severely disruptive, impact on the functioning of a significant portion of the United States capital markets and could interfere with the ability of employee benefit plan manage to invest plan assets in equity and debt securities through those capital markets. The temporary exemptions proposed by the Department of the Treasury and the Department of Labor would substantially alleviate these concerns, and would enable employee benefit plans and broker-dealers to continue to do business in the customary way, pending resolution of the complex issues involved in interpreting and implementing provisions of ERISA in question. Accordingly, the Commission strongly supports the exemptive provisions which have been published for public comment.

A. Possible Interpretations of ERISA Which Would Have Particularly Disruptive Effects on the Capital Markets and Would Impede the Ability of Employee Benefit Plan Managers to Invest Plan Assets

Services provided by broker-dealers to employee benefit plans include, *inter alia*, execution, either as principal or agent, delivery, clearance and settlement of transactions in securities; research; portfolio valuation; custody of securities; financing of margin accounts; and communications.[3] Arguably, the performance of any one of these services by a broker-dealer for an employee benefit plan creates a "party in interest" relationship between the broker-dealer and the plan since the definition of "party in interest" in Section

3(14) of ERISA[4] includes “a person providing services” to a plan. The Act provides no guidance as to the temporal duration of a relationship created thereby, or the extent of services which, if performed for a plan, create such a relationship. Once a party in interest relationship is established, however, the result, under the terms of the Act, is quite clear: a party in interest is effectively precluded from selling to, or exchanging property with, the plan,[5] or from extending credit to the plan.[6]

In addition, a party in interest may be prohibited from performing more than one service for a plan.[7] Thus, after directing a portfolio brokerage order to a particular broker-dealer, a. fiduciary managing or administering a plan may be prohibited from permitting that broker-dealer to perform other traditional services normally provided customers— such as extending margin credit or providing custody and research services.[8] Nevertheless, it would appear that Section 414(c)(4) of the Act generally would permit such multiple services to be provided to a plan by a party in interest until June 30, 1977.

In addition to becoming a party in interest under ERISA, a broker-dealer providing the services enumerated above may be considered to be a “fiduciary” as that term is defined in Section 3(a)(14) of the Act.[9] As noted above, broker-dealers traditionally, have provided research services and investment advice freely to customers at large in the hope of receiving brokerage orders.[10] This advice may include factual research on the economy, money markets, specific industries and individual companies, as well as

performance evaluations.[11] The professional counsel and research service generally provided by brokerage firms is normally considered to be incidental to the brokerage business,[12] although its importance to employee benefit plans cannot be overstressed.[13] It is possible that the definition of fiduciary in ERISA could be read to encompass one who provides investment advice compensated by additional brokerage business rather than by a fee.[14] In addition, Section 3(14)(A) of the Act could be read to indicate that a broker providing other traditional brokerage services for a plan, such as custody of securities, is also a fiduciary.

If, for any of the above reasons, a broker-dealer becomes a party in interest or a fiduciary with respect to a plan, Section 406 of the Act would operate to preclude that broker-dealer from selling securities to, or buying securities from, the plan as principal. Moreover, if the term "services" in the phase-in provision (Section 414(c)(4) of the Act) is read to exclude sales or exchanges of property, the prohibited transaction section referred to above would apply immediately (and, indeed, would have been applicable since January 1, 1975).

The importance to the capital markets of the willingness of broker-dealers to put their own capital at risk cannot be overestimated. Broker-dealers provide liquidity and depth to the market place by buying and selling securities as principal on a regular basis, from and to customers in the capacity of specialists on registered national stock exchanges;[15] as over-the-counter market makers in listed (the "third market");[16] and unlisted

securities;[17] as market makers in corporate debt securities, [18] municipal and state government securities,[19] government agency securities,[20] and U.S. Government securities;[21] as *bona fide*[22] and risk arbitraguers;[23] and as block positioners.[24] In addition, broker-dealers put their capital at risk in firm commitment, underwritten offerings involving primary and secondary distributions of debt and equity securities.[25]

The major difficulty presented by the provisions of ERISA, and the possible interpretations and constructions of those provisions discussed above, therefore, is that a plan would be prohibited from buying securities from, or selling securities to, a broker-dealer acting as a specialist, market-maker, firm commitment underwriter or arbitrageur, if that broker-dealer has become a party in interest or a fiduciary with respect to the plan. This possible interpretation of the Act has created major uncertainties within the broker-dealer community. It is our understanding that some counsel have cautioned their clients that the only safe course is to deal with a covered pension account solely in a principal capacity, or solely in a brokerage capacity, but not both.

B. Disruptive Effects of Certain Interpretations of the Act on the Capital Markets and on the Ability of Employee Benefit Plan Managers to Invest Plan Assets in Those Market

If the interpretations discussed above were to be implemented, the Commission believes that employee benefit plans may well be effectively denied access to a substantial portion of the services provided by broker-

dealers in the nation's capital markets and would thereby be restricted in their ability to seek and to obtain diversified investments in a wide range of corporate and governmental debt and equity securities, at prices and at times most advantageous to the plans and their beneficiaries.

As is discussed below, the performance of risk-taking and capital commitment functions in the securities industry is relatively concentrated. Firm commitment underwritings, block positioning and debt market-making, in particular, require commitments of extraordinary amounts of capital, and the number of broker-dealers capable of providing such capital is limited. In addition, these same broker-dealers provide highly effective and competent execution capability and are used often by employee benefit plans that must invest large amounts of their assets in the capital markets.

1. Investment Characteristics of Pension Funds

At the end of 1973, private noninsured pension funds[26] held about $90 billion worth of corporate stock or about ten percent of all such stock outstanding. Thus, private non-insured pension funds as a group comprise the second largest category of institutional investors, after personal trust funds, in the United States. In addition to their significant holdings of equity securities, pension funds are active traders in the stock market. In 1973, for example, combined stock purchases and sales by pension funds amounted to about $35 billion more than the purchases and sales by any of the other institutional groups with respect to which the Commission receives regular information. In

the first nine months of 1974, stock purchases and sales by pension funds aggregated $16.6 billion as compared to a combined total of $23.7 billion for open-end investment companies, life insurance companies and property-liability insurance companies. Private noninsured pension funds are also large holders of debt securities. At the end of 1973, pension funds held about $30 billion worth of corporate debt securities and over $4 billion in U.S. government and federal agency obligations.[27]

2. Securities Industry Profile

Although broker-dealers manage less than two percent of private pension fund assets for a fee, they are a vital link between the pooled savings of individuals and the issuers of securities: corporations, state and local governments, and the federal government. In almost all securities transactions, broker-dealers — either as agent or principal — are essential intermediaries.

The securities industry is less concentrated than most industries, but, as in other major industries, large national and regional firms make up the backbone of the industry, accounting for a major share of service capability.[28] More significantly, the same broker-dealer firms which are major factors in the underwriting, dealer and block-positioning markets also provide a major share of agency services for transactions in stocks and bonds. For example, at year-end 1973, the 25 largest brokerage firms accounted for not only 46.2 percent of agency commissions on securities transactions, but also for 46.6

percent of the underwriting income and 50.5 percent of the dealer revenues of the industry. The 50 largest broker-dealers accounted for 60.1 percent of agency commissions, 55.6 percent of underwriting income and 54.0 percent of dealer revenues. Further, half of the approximately two dozen government bond dealers are brokerage firms; they provide an important competitive force in the government bond markets, stimulating lower spreads and costs to investors than would otherwise occur. There are probably now less than twenty block positioning firms, all of which are among the largest 50 firms[29] in the securities industry.

3. **Impact of the Immediate Application of ERISA on Employee Benefit Plans, the Capital Markets and the Securities Industry**

A fiduciary managing a pension plan with a sizeable amount of assets normally would effect plan portfolio transactions through, and receive research and investment advice from, a fairly large number of brokerage firms, many of which would be the biggest, and most highly capitalized, firms in the industry. Since these same firms are major factors in the underwriting of new and secondary issues of debt and equity securities, and are major factors in the over-the-counter market for exchange-listed equity securities, the corporate debt market, the governmental agency securities market, the U.S. government securities market, and the state and local government bond market, a plan manager would find that, if the interpretation of the terms party in interest and fiduciary discussed *supra* were adopted, the avenues through which a plan might invest its assets would quickly be exhausted.[30]

Most institutional investors, including pension funds, frequently engage in large transactions, requiring the expertise of a block trader.[31] The mechanism of block trading developed in response to the increased institutionalization of the equity markets and the inadequacy of then-existing mechanisms to handle institutional size orders efficiently.[32] Often, to complete a block trade, the broker-dealer will be willing — or may be obliged — to buy or sell as principal whatever difference (in size) exists in matching the interest of the purchasing customer(s) with the selling customer(s), and thus may "position" the imbalance.[33]

This risk-taking willingness and capability is of great benefit to institutions insofar as it increases liquidity and depth in the marketplace, and enables institutions to sell and buy large blocks with a minimum discount from, or premium over, the prevailing market price. Since pension plan portfolios often are concentrated in equity securities, plans, like other institutional investors, must rely heavily on the small number of block positioners willing to risk large amounts of capital in the marketplace. If a broker were prohibited from positioning part of a block involved in effecting a cross for a pension fund, the result would be to make plan equity assets much less liquid than they are today.[34]

It is possible that certain brokers may decide, again assuming *arguendo* the interpretations noted *supra*, that the business of employee benefit plans is so important that they should segregate their functions and deal with covered plans either only as agent or only as principal. But, it seems anomalous that

Congress would have intended to effect a major policy decision such as this type of segregation of broker-dealer functions indirectly, through ERISA, rather than directly through amendments to the federal securities laws.[35]

In addition, the segregation, of broker and dealer functions at this time could be a serious blow to the securities industry.[36] Of the 2,164 broker-dealers registered with the Commission, which did a public business and had gross securities income of at least $20,000 in 1973, 1,472 engaged in either underwriting or principal business (or both), and agency (brokerage) business. If these general securities firms were to be forced immediately to limit the services they provide employee benefit plans to a single activity (i.e.. agency, dealer or underwriting), there would be a substantial decline in competition in the service markets currently used by such plans and their managers, and possibly a correlative increase in the costs of these services to employee benefit plans.

An SEC report profiling the securities industry in 1971 indicates that, of 459 New York Stock Exchange members which reported exchange commissions as a primary source of income, 93 reported underwriting activities as their secondary source of income, 39 (primarily larger firms) listed dealer activities in corporate bonds and over-the-counter stocks as their secondary source of revenue and reported government or municipal bond dealer revenue as their secondary source of income. Among over-the-counter firms[37] and regional exchange member firms,[38] similar over-lapping occurs between market -making, agency, government and municipal bond, and

underwriting activities. *See generally* Office of Economic Research, Securities and Exchange Commission, *The Broker-Dealer Community; Historic Trends and Current Financial Structure* (March, 1973).

If a large number of firms determined to act as agents for employee benefit plans and their managers, these same firms could not compete as bond dealers, block positioners, underwriters or market-makers in over-the-counter securities for such plans. Unnecessarily forcing broker-dealers to withdraw as competitors in the provision of such services to employee benefit plans may well be detrimental to the plans, the markets, other investors and to the corporations and governmental units seeking to finance their activities through the capital markets.

C. The Proposed Exemptions From Prohibitions On Certain Transactions Between Employee Benefit Plans and Certain Broker-Dealers Are Administratively Feasible, and Are In The Interests Of, and Protective Of The Rights Of, Employee Benefit Plans, Their Participants, and Beneficiaries.

The Commission believes it essential, and in the best interests of employee benefit plans, and the participants in, and beneficiaries of, such plans, that the uncertainties as to the proper interpretation and application of the provisions of the Act discussed above be resolved as promptly as possible. The immediate application of the prohibited transactions sections of the Act to certain customary and traditional activities of broker-dealers could cause severe and unnecessary disruption of the capital markets, contrary to the

interests, among others, of employee benefit plans, without concomitant benefits or protections to such plans or their participants and beneficiaries.

Resolution of the uncertainties with respect to these sections of the Act, and the exercise by the Secretaries of Labor and the Treasury of the exemptive powers granted to them by the Act, will require careful and deliberate consideration of all aspects of the complex problems involved, and the proposed interim exemptions would provide at least some time for resolution of these problems in a manner which will best serve the public interest and the interests of employee benefit plans and their beneficiaries and participants. Accordingly, the Commission strongly supports the prompt m adoption of the proposed exemptions.

1. The Proposed Exemptions Are Administratively Feasible

In the Commission's view, the proposed interim exemptions are administratively feasible, and, indeed, administratively desirable, both from the point of view of the Departments of Labor and the Treasury, and employee benefit plans. The temporary exemptions, if adopted as proposed would enable the Secretaries of Labor and the Treasury to consider the views and comments of all interested persons, including representatives of other government agencies, if appropriate, on the complex issues outlined above. The exemptions also would provide sufficient time within which to determine and to implement the best possible long-term solutions to these problems by administrative action, and to seek legislative clarification of any matters

which more appropriately should be resolved by the Congress. In this regard, the Securities and Exchange Commission and its staff will be available for consultation, and stand ready to provide any other assistance which may be desired by the Departments of Labor and the Treasury, or by the Congress.

More importantly, during the period when the proposed exemptions would be in effect, the capital markets, the securities industry, and employee benefit plans could continue to function in the normal course without serious disruptions in their day-to-day business activities,[39] and the other adverse consequences which likely would flow from the immediate application of the provisions of Section 406(a) of the Act, and the parallel provision of the Internal Revenue Code of 1954. Finally, even if all issues with respect to the provisions of the Act in question are not resolved on a long-term basis, the temporary exemptions will give those persons whose business practices would be drastically affected by these provisions an opportunity to attempt to readjust the manner in which they presently do business, and to become familiar with the full scope of the obligations, responsibilities and liabilities imposed by the Act.

2. The Proposed Exemptions Are In The Interests of Employee Benefit Plans, Their Participants, and Beneficiaries

Pending resolution of the issues outlined above, the proposed temporary exemptions would enable employee benefit plans to continue to receive the full-range of valuable services presently provided by broker-dealers, to retain the essential access to all segments of the capital markets,

upon which they must rely, to make new investments on attractive terms and to obtain and retain sound and diversified investments for their portfolios. For these reasons, the Commission believes that the proposed temporary exemptions are in the interests of employee benefit plans, their participants and their beneficiaries. In addition to serving these interests, the proposed exemptions also would assure that pension plans could continue to fulfill their vital role in supplying much-needed capital to American industry during the next few months — a time when new capital will be essential to facilitate the growth and expansion of industry necessary to provide jobs and prosperity for the American people.

3. The Proposed Exemptions Are Protective of the Rights of Employee Benefit Plans, Their Participants and Beneficiaries

In addition to the foregoing considerations, the Commission believes that the proposed temporary exemptions will protect the rights of employee benefit plans, their beneficiaries and participants, particularly in light of the fact that the transactions between broker-dealers and plans, which would be permitted to continue during the limited periods covered by the exemptions, would be subject to the significant safeguards provided by the express terms of the proposed exemptions, and the provisions of other applicable laws. The exemptions would be available only to transactions which are "at least as favorable to [a] . . . plan as an arm's, length transaction with an unrelated party would be . . . "

Further, the types of transactions which would be covered by the proposed exemptions are those in which broker-dealers and plans historically have engaged in the ordinary course of business. Finally, the substantial protections provided by the provisions of existing law, and particularly the fact that the securities markets and the securities industry are and will continue to be subject to comprehensive regulation by the Securities and Exchange Commission, under authority granted to the Commission by the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, also will serve to protect the interests of plans and their beneficiaries and participants while these exemptions are- in effect.[40]

* * *

For the foregoing reasons, the Commission believes the proposed exemptions should be adopted as promptly as possible.

EXHIBIT A

SECURITIES AND EXCHANGE COMMISSION
OFFICE OF THE CHAIRMAN
WASHINGTON. D.C. 20549

January 9, 1975

Honorable Richard F. Schubert
Under Secretary of Labor
U.S. Department of Labor, Room 3126
Washington, D.C. 20210

Honorable Donald C. Alexander
Commissioner
Internal Revenue Service .
1111 Constitution Avenue, N.W.
Washington, D. C.

Dear Sirs:

It has recently come to the Commission's attention that several broker-dealers and their counsel are of the opinion that certain constructions of the "prohibited transactions" provisions of the Employee Retirement Income Security Act ("ERISA" or "Act"), which became effective on January 1, 1975, may require that broker-dealers refrain from trading as principal with employee benefit plans to which they provide services. This may have an immediate, wide-spread and detrimental impact on the operation and functioning of a significant portion of the United States capital markets, and

may serve to restrict the ability of employee benefit plan managers to invest plan assets in equity and debt securities.

The Commission is greatly concerned about the potential severe disruption and dislocation in the capital markets, and the probable concomitant negative impact on employee benefit plans and their beneficiaries, which may occur, if, as a result of the present uncertainties concerning the scope and application of these provisions of ERISA to the activities of broker-dealers, a substantial portion of the business transacted between employee benefit plans and broker-dealers is suddenly terminated or substantially curtailed.

Broker-dealers currently provide, and historically have provided, a wide range of services to employee benefit plans including, among others, investment management, brokerage, research analysis, custody of funds and securities portfolio valuation. In addition, the broker-dealer community now provides employee benefit plans with the opportunity to participate in underwritten primary and secondary offerings of equity and debt securities and provides liquidity and depth i the secondary trading markets for plans, as well as other investors, by buying and selling securities for their own account (as "principal") and by making two-sided markets in such securities. Thus, if a plan manager decides to sell a portfolio position in a particular corporate debt instrument, it will normally sell to a broker-dealer making a market in the particular security.

The Commission's concern is focused on a possible reading of Sections 3(14), 3(21), 406 and 414(c)(4) of, the Act (and the corresponding provisions of Section 4975 of the Internal Revenue Code of 1954, as amended), which may serve to disrupt immediately existing business relationships in an unintended manner antithetic to the interests of employee benefit plans and their beneficiaries. For example, if a broker is considered a "party in interest" to a plan (as that term is used in Section 3(14) of the Act), by virtue of effecting an agency transaction for the plan, the plan would be prohibited from purchasing securities from that broker-dealer acting in a market-making capacity. Similarly, after effecting a brokerage transaction through a particular broker-dealer, a plan fiduciary-manager would not be permitted to purchase securities from that broker-dealer as principal in an underwritten offering, or to purchase or sell securities f or to the same broker-dealer in the corporate debt market, government agency securities market, the over-the-counter market in listed and unlisted securities and even the exchange market for listed securities.[41] In addition, the same immediate disruption of relationships could occur for those broker-dealers that -are or could be considered to be "fiduciaries" to a plan under Section 3(21).

Because a large number of employee benefit plans effect securities transactions through the broker-dealer community, many brokers, who, on an agency basis, provide execution and other customary brokerage services for employee benefit plans, may be deemed to be a "party in interest" with respect to such plans.[42] Thus, to the extent that employee benefit plans wish to utilize for execution the largest and best capitalized broker-dealer firms, those

plans may be limited severely in their ability to buy and sell securities in the substantial segment of the market where transactions primarily occur on a principal basis, since many of the same large and well capitalized broker-dealer firms are the leading factors in such markets.[43] This would be an unfortunate result not only for the capital markets and employee benefit plans, but also would have a negative impact on the securities industry.[44]

The present application of the Act, with the broad-reaching possible interpretations outlined above remaining unresolved, would appear to be unfortunate, especially at this particular time. January and February are traditionally major months for the public offering of new debt issues, and the dollar volume to be offered during this January and February is expected to be the highest ever. These issues provide new capital which is badly needed by American industry, including public utility companies whose difficulties in raising new capital have been widely noted. Any legal fears that would impede the participation of employee benefit plans in supplying this needed capital may well have an adverse effect on American industry at this critical time and could deprive the plans of the chance to make new investments on attractive terms.

While we recognize the importance of these provisions of ERISA, we think the need for their immediate application is mitigated by the fact that the securities markets and the securities industry are and will continue to be subject to comprehensive regulation by the Securities and Exchange

Commission, under authority granted to it% by the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.

The Commission believes it is essential that the uncertainties concerning the proper construction of the provisions of the Act discussed above be resolved as promptly as possible to avoid unnecessary disruption of the capital markets. But, the Commission recognizes that resolution of these uncertainties, as well as the proper exercise by the Secretaries of Labor and the Treasury of the exemptive powers granted to them by the Act, necessarily will require careful and deliberate consideration of all aspects of the complex problems involved, and sufficient time to reach decisions which best will serve pension plans and their beneficiaries. Accordingly, the Commission strongly urges you to defer the effectiveness of the provisions of the Act discussed above, as to broker-dealers, to allow sufficient time properly to resolve these questions.

Sincerely,

Ray Garrett, Jr.
Chairman

ENDNOTES

[1] Pub. L. No. 93-406 (Sept. 2, 1974).

[2] On January 9, 1975, the Commission sent a letter to the Honorable Richard Schubert, Under Secretary of Labor, and the Honorable Donald Alexander, Commissioner of the Internal Revenue Service, expressing the Commission's concern with respect to possible adverse consequences which might flow from the immediate application of various provisions of ERISA to certain transactions between employee benefit plans and broker-dealers in securities. A copy of that letter is attached hereto as Exhibit A, for the record in these proceedings.

[3] For a discussion of the services provided by broker-dealers to institutional investors, *see* Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. pt. 4 at 2255-64 and 2273-74 (1971) [hereinafter cited as Institutional Investor Study].

[4] References are to provisions in Title I of ERISA; however, these comments apply as well to the corresponding provisions in Title II of the Act, amending the Internal Revenue Code of 1954.

[5] Section 406 (a) (1) (A) of the Act.

[6] Section 406(a)(l)(B) of the Act.

[7] Section 406(a)(l)(C) of the Act. This result appears inconsistent with language in the Act's legislative history, which suggests that the prohibition against providing multiple services is not to apply to parties in interest provided they are not also fiduciaries. *Joint Explanatory Statement of the Committee on Conference*, S. Rep. No. 93-1090, 93d Cong., 2d Sess. 314 (1974) [hereinafter cited as *Conference Report*].

[8] Under the fixed rate system, institutional customers of stock exchange members have often been able to -bargain for additional services over and above those traditionally provided to smaller retail customers, such as direct wire connections between the member and the customer, portfolio valuation, and special research, without the imposition of an additional charge. *See*, *In the Matter of SEC Rate Structure Investigation of National Securities Exchanges*, Commission File No. 4-144 at 86-88 and 113-114 (1968-1971). These services, even though provided without additional charge in a highly competitive service atmosphere, also may be prohibited since, if a broker is a party in interest, all multiple services might be prohibited without regard to whether compensation is involved. *See* Section 3(14) and Section 406 of the Act.

[9] With one exception not relevant for purposes of this discussion,

> " . . . [A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders

> investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or . . . has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan." Section 3(21)(A) of the Act.

This definition clearly encompasses those broker-dealer who have discretionary authority over the management of employee benefit plan assets, including "investment managers" appointed under Section 402(c)(3) of the Act. The term "investment manager" is defined in Section 3(3 of the Act as a

> "fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2)) — (A) who has the power to manage, acquire, or dispose of any asset of a plan; (B) who is (i) registered as an investment adviser under the Investment Advisers Act of 1940; . . . and (C) has acknowledged in writing that he is a fiduciary with respect to the plan."

It also should be noted that any "fiduciary" with respect to a plan is a "party in interest." Section 3(14) of the Act.

[10] Securities and Exchange Commission, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1 at 330-333 (1963) [hereinafter cited as *Special Study*]. •

[11] *Institutional Investor Study* pt. 4 at 2263.

[12] Section 202(a)(11)(C) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(11)(C), excepts from the definition of investment adviser "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."

[13] The *Institutional Investor Study* found that the research and information provided by broker-dealers is considered by "self-administered" pension plans to be second only in importance to issuer reports in providing useful information about issuers of securities. *Institutional Investor Study*, pt. 3 at 1037-38.

[14] Query whether a broker that became a fiduciary by virtue of providing such research services would thereby be obligated to fulfill other responsibilities of a fiduciary under the Act, such as the requirement to diversify plan assets (Section 404(a)(1)(C) of the Act). This would be an impossible task for someone having no actual control over the portfolio investment policy of a plan.

Two other problems have come to our attention which we note for the record but which we do not believe need be addressed in connection with this hearing:

(1) As the Departments are aware, the Commission has requested that registered national securities exchanges abolish the practice of fixing rates of commission by May 1, 1975. *See* Securities Exchange Act Release No. 11019 (Sept. 19, 1974), 39 Fed. Reg. 35214 (Sept. 30, 1974); Securities Exchange

Act Release No. 11073 (Oct. 24, 1974), Fed. Reg. 38396 (Oct. 31, 1974). This issue should be resolved finally within the month. If fixed rates are eliminated, one would expect that brokerage firms will continue to offer their investment research and portfolio advice freely to all customers, but some customers may determine to compensate the broker with cash ("hard dollars") rather than brokerage commissions ("soft dollars"). Although the broker-dealer would be providing research in a capacity closely analogous to that discussed in the text— namely as a service incidental to his business as a broker-dealer, he would appear to fall squarely within the definition of fiduciary were he to do so, despite the fact that he would have no actual management function with respect to the plan.

(2) A broker-dealer offers, as part of his agency function, to "work" an order for a customer. A customer may determine, for example, that because of the size and difficulty of a particular execution, it would be unwise to commission a market order or a limited price order. In such circumstances, the customer will retain a competent broker and will grant "temporary" discretion to the broker to use his professional expertise and effect the order in the most advantageous manner possible. Some might read the definition of fiduciary, which includes one who exercise discretionary control over "disposition of . . . [the plan's] assets," to include a broker handling such an order.

[15] *Special Study* pt. 2 at 78-142. *See also Institutional Investor Study* pt. 4 at 1829-1926.

[16] *Special Study* pt. 2 at 870-911.

[17] *Id.* at 554-595.

[18] *The Stock Market Handbook* 906-908 (F. Zarb & G. Kerekes ed. 1970).

[19] *Id.* at 248.

[20] *Id.* at 236-241.

[21] *Id.* at 240-241.

[22] *Id.* at 325-328.

[23] G. Wyser-Pratte, *Risk Arbitrage* 9-10 (1971).

[24] *Institutional Investor Study* pt. 4 at 1932-1948.

[25] *The Stock Market Handbook* 54-71 (F. Zarb & G. Kerekes ed. 1970) ; *Special Study* pt. 1 at 559-568.

[26] The data set forth herein were collected prior to the effective date of ERISA and include information with respect to deferred profit sharing funds and pension funds of corporations, unions, multi-employer groups and nonprofit organizations.

[27] The *Institutional Investor Study* survey of corporate pension funds found the following portfolio composition cash, one percent; governments and short-term nongovernment debt securities, five percent; mortgages, re estate and “other” assets, ten percent; non-government long-term debt securities, nineteen percent; and equity securities, sixty-five percent. *See Institutional Investor Study*, pt. 3, Table VIII-32 at 1072-1073.

[28] The Commission's *Institutional Investor Study* found that, in a sample of 84 first offerings, 33 underwriters accounted for 51 percent of all sales to institutions. *Institutional Investor Study* pt. 5 at 2335.

[29] Block positioning may be the most highly concentrated of all the risk capital functions. In 15 out of 21 months sampled by the *Institutional Investor Study*, five firms accounted for sixty percent of the total positions of all firms. In addition, the Study was able to identify only 41 firms that had positions in their block positioning accounts at some time during the period sampled. *Institutional Investor Study* pt. 4 at 1932-1936.

[30] Presumably, a fiduciary would not be permitted to direct portfolio orders to an independent broker and thereby claim insulation from the liability provisions of the Act in the event the independent broker dealt with a market-maker that was also a party in interest with respect to the plan. In any case, whether or not this interpretation of ERISA would be adopted, “interpositioning” an unnecessary broker between a plan and the best market

maker is not a practice that should be encouraged. *See, e.g., Provident Management Corporation*, Securities Exchange Act Release No. 9028 (Dec. 1, 1970); *Delaware Management Co., Inc.*, Securities Exchange Act Release No. 8128 (July 19, 1967).

[31] In this regard, it should be noted that Congress apparently intended to provide at least one exception from the prohibitions in Section 406 of the Act to accommodate a transaction which is "an ordinary 'blind' purchase or sale of securities through an exchange where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved." *See* Section 406(a)(1) of the Act and Conference Report at 307. This exception appears intended to permit an ordinary, regular way brokerage transaction to be effected on the floor of a national securities exchange, without liability under the Act, even though the person on the other side of the transaction happens to be a party in interest.

[32] See *Institutional Investor Study* pt. 4 at pp. 1932-1961, 1537-1735.

[33] Block positioning is generally considered a service by brokerage industry. Overall, the positions taken by bio traders are not themselves profitable, *see Institutional Investor Study* pt. 4 at 1938-39, but by performing this "service" the block trader hopes to profit from the brokerage commissions earned on both the trade involved and future business. *Id.* at 1939.

[34] Presumably, a block trader would not be prohibited simply from effecting a cross transaction on behalf of a plan so long as the principal on the other side was not, in fact, a party in interest with respect to the plan.

[35] Prior to the passage of the Securities Exchange Act, Congress considered prohibiting any broker transacting business on a national securities exchange from acting as a dealer in securities. S. 2693 and H.R. 7852, 73d Cong., 2d Sess. §10 (1934). In view of the potential disruption of the markets which might result from segregation of these functions, Congress instead directed the Commission to study the question. Senate Committee on Banking and Currency, *Stock Exchange Practices Report*, Rept. No. 1455, .73d. Cong., 2d Sess, 29-30 (1934); Securities Exchange Act of 1934 §11(e), 15 U.S.C. 78k(e). The Commission report recommended against such a segregation. *Securities and Exchange Commission Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* (G.P.O. ed., 1936).

[36] Securities commission income of NYSE member firms doing a public business totaled $1.9 billion in the first ten months of 1974, ten percent less than the same period a year earlier and about one-third less than the comparable 1972 period. Gross revenue for these same reporting firms totaled almost $3.8 billion, only slightly lower than the preceding year. While comprehensive current data for the industry is not available, net income (before partners' compensation and taxes) totaled $5 million in 1973 as compared to almost $1.0 billion in 1972 and $1.3 billion in 1971.

[37] Of the 597 over-the-counter firms whose primary source of revenue was agency OTC business, 145 acted as market-maker for some securities, 82 participated in underwriting activities and 46 acted as government and municipal bond dealers. Of 179 OTC firms that reported that their primary or secondary activity was as a government or municipal bond dealer, at least 96 listed agency OTC or mutual fund sales as the other major activity.

[38] Among member firms of regional exchanges and the American Stock Exchange, which were not members of the NYSE, 45 were concurrently acting as agent on exchange transactions and as OTC market-makers, participants in underwritings or as government and municipal bond dealers. Of the 40 regional exchange and Amex members whose primary activity was as dealer for government or municipal bonds, 24 cited agency activities in listed and OTC securities and another ten reported underwriting activities as their secondary source of revenue.

[39] In another context, the Congress indicated its concern about the possible short-term disruptive .effect this legislation might have, stating that:

> "To prevent undue hardship, the [Act] . . . also provides transition rules for situations where employee benefit plans are now engaging in activities which dp not violate current law, but would be prohibited transactions under the [Act] . . . "
> *Conference Report* at 325.

[40] It also should be noted that the types of transactions which would be permitted under "Phase Two" of the proposed exemptions, covering the period from February 15 to April 30, 1975, would not have been prohibited by the "separate legislation" referred to in the Conference Report. *See* S. 470, 93d Cong., 1st Sess. §2 (1973); H.R. 5050, 93d Cong., 2d Sess. §205 (1974); and *Conference Report* at 310.

[41] Although the Conference Report suggests that "a transaction will not be a prohibited transaction . . . if the transaction is an ordinary 'blind' purchase or sale of securities through an exchange where neither buyer nor seller (nor the agent of either) knows the identity of' the other party involved," S. Rep. No. 93-1090, 93d Cong., 2d Sess. 307 (1974), this is insufficient to assure liquidity for large portfolio positions in common stock held by many employee benefit plans. Liquidity in large blocks requires the risk-taking capability of a block positioner who, as agent., would place as much as possible of the block with interested institutional customers and put its own capital at risk to absorb the remainder. *See* Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st . Sess., pt. 4, Chapts. XI and XII(J), pp.1397-1465and 1956-1961 (1971).

[42] At the end of 1973, for example, corporate pension funds held $90 billion of corporate stock (exceeded only by personal trust funds as an institutional group), representing almost ten percent of all stock outstanding. In addition to their significant holdings, pension funds are active institutional traders in the

stock market; in the first half of 1974, for example, combined stock purchases and sales by pension funds amounted to over $12 billion — more than the purchases and sales by any of the other institutional groups for which the Commission receives regular information.

[43] In 1973, 2,164 broker-dealer firms reported gross revenues of $5.5 billion; the ten largest reporting firms accounted for 32.4 percent of the total and the fifty largest reporting firms for 61.9 percent. In the underwriting, of new issues, the ten largest reporting firms accounted for 34.6 percent of total underwriting revenue and the fifty largest for over seventy percent. *See also* Securities and Exchange Commission, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Gong., 1st Sess., Pt. 2, (1963), p. 548.

[44] The current state of the securities industry reflects the current and continuing depressed state of the securities markets. The Dow-Jones industrial average closed the year 1974 at 616.24, the second annual decline. Securities commission income of NYSE member firms doing a public business totaled $1.9 billion in the first ten months of 1974, ten percent less than the same period a year earlier and about one-third less than the comparable 1972 period. Gross revenue for these same reporting firms totaled almost $3.8 billion only slightly lower than the preceding year. While comprehensive current data for the industry is not available, net income (before partners' compensation and taxes) totaled $57 million in 1973 as compared to almost $1.0 billion in 1972 and $1.3 billion in 1971.