

STABLE VALUE CONTRACTS

This document describes how the financial services reform bills could inadvertently do great harm to stable value funds, which are a very popular investment in 401(k) and other retirement plans. Also set forth below is a solution that does not involve a “carve-out” of stable value funds and thus is consistent with the intended broad scope of the bills.

Background

In general. Stable value funds are an extremely popular investment offered under 401(k) plans and similar arrangements (such as section 457(b) plans maintained by State or local governments); these funds are also used outside the retirement plan context, such as in section 529 qualified tuition plans. Over half of all defined contribution plans offer a stable value fund investment and 15-25% of all plan assets are invested in such funds. Stable value funds are popular because they offer individuals, including those in or near retirement, a safe investment that combines capital preservation with a reasonable guaranteed rate of return; in these turbulent times, many individuals need this protection against market fluctuation.

The funds generally invest in a well-diversified portfolio of high-quality fixed income securities. In addition, the funds include a stable value contract that establishes a minimum rate of return and allows the funds to have a stable net asset value under most circumstances. It is the stable value contract that could be a “swap” under the House and Senate financial services reform bills.

Fiduciary issue. If stable value contracts are swaps, plans could be compelled to stop offering stable value funds for three reasons. First, treating stable value contracts as swaps could make the contract issuer a swap dealer under the bills. Under the Senate bill, the issuer, as a swap dealer, would owe a fiduciary duty to the plan. This would, in turn, force the contract issuer to represent both parties to the contract, which is practically and legally unworkable.

Eligible contract participant issue. Even if the fiduciary issue is solved, the rules regarding who can purchase a swap could create an enormous problem for stable value funds. Since stable value funds are not exchange-traded and do not lend themselves to exchange-trading, any purchaser of a stable value fund containing a swap must be an “eligible contract participant”. Any person who is not an eligible contract participant may not purchase a fund containing a swap. If a participant in a 401(k) plan invests in a stable value fund, is it the plan or the participant who is the purchaser for purposes of the bill and thus must meet the eligible contract participant rules? There is no clear answer to this question in the bill. We strongly believe that the plan is the purchaser, but the agencies could take the position that the purchaser is the participant, in which case a de minimis portion of all participants would meet the \$5 million investable asset requirement to qualify as an eligible contract participant. Even if the purchaser is the plan, many small business plans would fail the \$5 million total asset requirement applicable to plans.

Regulation. In addition, the issuer of the stable value contract would, if treated as a swap dealer or major swap participant, be required to satisfy numerous rules, including capital

and margin requirements. It is unclear how these requirements would apply, but it is certainly possible that they would materially increase contract issuers' costs, thus reducing the rate of return that can be guaranteed and hurting participants.

Uncertainty. If the bill were to pass without addressing the stable value issue, there would be an immediate and chilling effect on the stable value market. There would be great uncertainty regarding (1) the applicability of the swaps rules to stable value funds, (2) the fiduciary issue, (3) the eligible contract participant rules, (4) and the applicability of the swap dealer/major swap participant rules to stable value contract issuers. This massive amount of uncertainty could well have a paralyzing effect on the stable value market; without immediate guidance, this product could be devastated, severely harming the millions of participants currently invested in it.

Summary. In short, the application of the swaps rules to contractual guarantees under stable value funds could undermine the viability of a very popular plan investment that protects millions of Americans in all income ranges from market fluctuation by providing capital preservation and a reasonable guaranteed rate of return. Furthermore, discussions with Congressional staff and Administration officials have made it clear that no one had contemplated treating stable value contracts as swaps and no one had thought about how the swap rules would apply to such contracts. Moreover, there is no demonstrated need to further regulate stable value funds, the issuers of which are already subject to significant regulation by State insurance commissioners or by banking regulators. And stable value funds have not played a role in the financial crisis, providing no basis for additional regulation.

Proposal

To address the above issues, we propose the following.

- The SEC and CFTC would be directed to review jointly the extent to which stable value contracts fall within the definition of a swap. To the extent that stable value contracts constitute a swap, the SEC and CFTC would be directed to determine whether the swap rules should apply to stable value contracts. If the SEC and CFTC determine that some or all swap rules should apply to stable value contracts, the SEC and CFTC should also determine how the rules should apply and as of what date. In making their determinations, the SEC and CFTC would be directed to consult with the Federal and state regulators that have existing regulatory jurisdiction over the institutions issuing such contracts.
- The SEC and CFTC would correspondingly be directed to jointly issue regulations reflecting their findings.
- Pending the issuance of such regulations, the swaps rules would not apply to stable value contracts. In short, the point of this proposal is to ensure that before a popular investment option is effectively eliminated, there is a careful review of how that option should be regulated. This proposal is not a carve-out; it is a recognition that new rules should not apply to a product before the government has had a chance to consider whether and how those rules should apply.