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1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

August 8, 2016

The Honorable Edmund G. Brown, Jr.
Governor of California
State Capitol, Suite 1173
Sacramento, CA 95814

Re: SB 1234, California Secure Choice Retirement Savings Program

Dear Governor Brown:

I am writing to bring to your attention the very high likelihood that California taxpayers and retirement savers will bear substantial unforeseen costs resulting from SB 1234, a bill to implement the California Secure Choice Retirement Savings Program ("Program"). We urge you to examine the Program closely and consider the significant risks—fiscal risks, legal risks, and, for California's workers, financial and investor protection risks—detailed below. In the face of those risks, we believe that the Program should not go forward.

The Investment Company Institute[1] strongly supports efforts to promote retirement security for all American workers. ICI's members have a unique role in promoting the future of our retirement system. About half of defined contribution plan and individual retirement account (IRA) assets are invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers. We commend the State of California for its interest in ensuring that its residents have sufficient resources for retirement and we share the goal of increasing workplace retirement plan access. We simply do not believe that SB 1234 presents a viable approach to achieving this important goal.

[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders.

You face a significant obstacle in making a well-informed and therefore a sound assessment of the merits of SB 1234. Regrettably, the limitations in the materials before you make your task all the more difficult. Bringing our research[2] to bear, we find that the materials used to support the Program do not identify or address the full range of possible challenges that the Program could face. The justification for the Program relies on a report by Overture Financial LLC that paints an overly optimistic picture of both the Program's likely take-up rate among California workers and the amount of contributions made by those who do participate. Significantly, the report understates the legal risks to the State of California inherent in the Program. In fact, California taxpayers or Program participants—most likely both—will likely find themselves bearing unanticipated costs as a result of the Program.

The ultimate cost of implementing the Program depends on many factors. These include legal and compliance costs relating to various federal laws with bearing on the Program, administrative costs of setting up and maintaining the Program, and potentially significant costs that may arise later if the Program experiences financial difficulties in providing promised benefits to participating workers. We expand on these various costs below.

- ***First, the Program faces substantial legal problems under ERISA that have not been sorted out.***[3] It is not at all clear how the Employee Retirement Income Security Act of 1974 (ERISA) will affect the operation of the Program. In particular, SB 1234 requires that, prior to implementation, the California Secure Choice Retirement Savings Investment Board (the "Board") must find that the Program accounts will qualify for the favorable federal income tax treatment accorded to IRAs under the Internal Revenue Code, and that the Program is not an employee benefit plan under ERISA. As you may know, the ERISA status of state-based programs is the subject of a pending rulemaking project at the U.S. Department of Labor (DOL).[4]

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[2] One of ICI's major roles is to be a source for statistical data and research on the investment company industry. ICI conducts public policy research on fund industry trends, shareholder characteristics, the industry's role in U.S. and international financial markets, and the retirement market. ICI publishes reports focusing on the overall U.S. retirement market, fees and expenses, and the behavior of defined contribution plan participants and IRA investors. ICI conducts periodic household surveys that connect directly with mutual fund investors, IRA owners, and 401(k) plan participants.

[3] We described these legal questions in our November 15, 2013 letter to Mr. Grant Boyken responding to the California Secure Choice Retirement Savings Program Request for Information, available at www.treasurer.ca.gov/scib/rfi/ici.pdf.

[4] DOL has proposed a regulatory safe harbor from coverage under ERISA for certain payroll-deduction IRA arrangements established and maintained by state governments. Savings Arrangements Established by States for Non-Governmental Employees, 80 Fed. Reg. 72006 (November 18, 2015). Under the safe harbor, these state arrangements would not be treated as employee benefit plans under ERISA, as long as specified conditions are met, including that state law requires certain employers to make the program available to employees. We do not believe that this proposal settles the ERISA status of any particular state-run program, as it has not been finalized and, even if finalized in its current form, application of the safe

Even after that DOL regulation is finalized, other questions will remain. One is ERISA preemption, which DOL has been clear to explain could only be determined by a court.[5] In addition, assuming for argument's sake that the Program is exempt from ERISA coverage and not preempted by ERISA, the IRAs created under the Program will be subject to the complex framework of prohibited transaction rules under the Internal Revenue Code and the broadly applicable new DOL regulation on fiduciary investment advice (which expressly applies in the IRA context in addition to ERISA-covered retirement plans).[6] This is an area that has received little attention by the proponents of the legislation.

- ***Second, it is unclear whether the investment options under the Program are even permissible under federal securities laws without extraordinary (and unexplored) costs.*** As the Board's own counsel has cautioned, the status of Program investments under federal securities law will have a tremendous impact on the costs of running the Program. We understand that the Secure Choice Board may be seeking guidance from the Securities and Exchange Commission (SEC) on those matters, but the SEC has not publicly issued that guidance.

- ***Third, California taxpayers may need to bail out the Program and the Program itself may generate lower-than-anticipated returns.*** The market analysis and financial feasibility report commissioned by the Board contains a great deal of survey data on the characteristics and views of workers without employer-provided retirement plan coverage. But many of the assumptions in the report, including the report's "pessimistic scenario," are overly optimistic. While the bill attempts to limit the State's liability under the Program, there exists a very real possibility that California taxpayers ultimately will need to bail out the Program.[7]

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harbor to any particular program would be a facts and circumstances determination that ultimately would rest in the hands of a court of law. As DOL noted, "the objective of the proposed safe harbor is to diminish the chances that, if the issue were ultimately litigated, the courts would conclude that state payroll deduction savings arrangements are preempted by ERISA." 80 Fed. Reg. 72009. DOL also notes that "courts' determinations would depend on the precise details of the statute at issue, *including whether that state's program successfully met the requirements of the safe harbor*." 80 Fed. Reg. 72011 (emphasis added).

[5] 80 Fed. Reg. 72009, 72011.

[6] Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (April 8, 2016).

[7] We understand that the legislation is still subject to amendment. The contemplated changes, however, appear to be unlikely to affect our economic analysis of the risks and costs of the Program.

> The bill also authorizes several management strategies that could impose significant costs to the taxpayers of California. The legislation authorizes a "reserve fund," for example, that gives the Board discretion to manage the participants' accounts in such a way that actual accruals of gains would be held back in order to create a reserve to shore up accounts in years that experience market downturns. The viability of such a reserve fund raises serious concern and the potential need for the State to intervene and shore up the fund with taxpayer dollars.

We discuss below our concerns in greater detail.

I. Legal Problems under ERISA Remain Unresolved.

Because of the significant costs and liabilities associated with establishing an ERISA-covered retirement savings plan, the Program is intended to be an IRA-based program exempt from ERISA coverage. We documented the obligations and responsibilities required by ERISA for private-sector employer-sponsored plans in our 2013 letter to the Board.[8] Rather than relying on existing DOL guidance for offering payroll-deduction IRAs not subject to ERISA, many states pushed DOL for a new safe harbor that would allow them to automatically enroll workers not already covered by a workplace plan into a state-run IRA program. That DOL proposed safe harbor is not yet final.

As currently drafted, certain provisions in SB 1234 would not even meet the proposed DOL safe harbor. For example, the DOL proposal requires that the employer's participation in the program be required by state law. SB 1234, however, would allow for voluntary participation in the Program by any employer, even if the employer is not subject to the bill's mandate. According to DOL, "if it is voluntary, the safe harbor does not apply."[9] Failure to meet any condition of the safe harbor generally would result in the Program being treated as an ERISA plan (assuming automatic enrollment of workers), and consequently the state and participating employers could be subject to liability under ERISA. More importantly, however, we reiterate that DOL is still in the process of finalizing the regulation and, until then, its conditions remain uncertain.

Perhaps even more important than the final conditions of the safe harbor are two matters acknowledged by DOL in the preamble to the proposed safe harbor for state-run IRAs.

ERISA could preempt the state law. First, the Program, even if it ultimately meets all conditions of the ERISA safe harbor, could be preempted by ERISA. The consequences of a finding of

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[8] *See* note 3, *supra*.

[9] 80 Fed. Reg. 72010.

preemption would be quite severe. The Program likely would need to be dismantled or at least significantly overhauled.

Section 514 of ERISA generally provides that Title I of ERISA supersedes any state laws insofar as they relate to any employee benefit plan described in section 4(a) of ERISA. Because the bill effectively conditions its mandate on an employer not offering an ERISA plan, the law if enacted would seem to "relate to" employee benefit plans covered by ERISA.[10] As DOL explained:

> [T]he fact that state programs do not create ERISA covered plans does not necessarily mean that, if the issue were litigated, the state laws would not be preempted by ERISA. The courts' determinations would depend on the precise details of the statute at issue, including whether the state's program successfully met the requirements of the safe harbor.[11]

Prohibited transaction rules will apply. Second, the DOL explains that the Internal Revenue Code's prohibited transaction rules would apply to any IRAs created under a state-based program.[12] Even if a state does not become a fiduciary under ERISA when offering an IRA-based program for private-sector workers, it could become a fiduciary or other type of disqualified person[13] under the Internal Revenue Code, which contains prohibited transaction rules applicable to IRAs that parallel ERISA's prohibited transaction rules.[14] Generally, the prohibited transaction rules prohibit disqualified persons from entering into (or participating in) transactions involving the plan or IRA that result in any benefit (direct or indirect) to the disqualified person.

The legislation grants the Board authority over the management of Program assets and contemplates the possibility that such management would be performed by California entities. Those are clearly fiduciary activities,[15] even if the state elects to contract with third-party service providers to provide investment or administrative services for the Program. The State easily could be seen as participating in any prohibited transaction engaged in by such service providers by virtue of its role in

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[10] It is possible that an interested party, such as an employer within the state that becomes subject to the mandate, could bring a legal challenge against SB 1234 on ERISA preemption grounds. The ERISA exemption for governmental plans would not apply here because the Program would cover private-sector employees instead of governmental employees.

[11] 80 Fed. Reg. 72011.

[12] 80 Fed. Reg. 72009.

[13] A "disqualified person" includes, among other things, a fiduciary to a plan or IRA and a service provider to a plan or IRA. Internal Revenue Code § 4975(e)(2).

[14] *See* Internal Revenue Code § 4975.

[15] A fiduciary would include any person who exercises any discretionary responsibility in the administration of the plan or IRA. Internal Revenue Code § 4975(e)(3).

selecting and monitoring the provider and making discretionary decisions, for example, with respect to the investments offered to participating workers. Violations of the prohibited transaction rules carry significant excise tax penalties, to be paid by any disqualified person participating in the transaction. There does not appear to be any exemption from these restrictions for states that are involved in setting up and running IRAs on behalf of their citizens. Indeed, DOL noted in the preamble to the proposed safe harbor that "by limiting the safe harbor to programs that use [IRAs], the proposal incorporates the applicable protections under the Code, including the prohibited transaction provisions."[16]

In addition to being subject to the prohibited transaction rules more broadly, the Program also would fall under the purview of the new DOL rules defining who is a fiduciary by virtue of providing investment advice for a fee.[17] The DOL rule expressly applies to advice to IRAs (and IRA owners) not governed by Title I of ERISA.[18] The rule has a very broad definition of advice, and would appear to cover involvement in distribution decisions, selecting investment options (including default investments), and certain interactions with call center representatives, among other activities. Again, the state should consider the potential cost implications of becoming a fiduciary itself, and potentially of being legally implicated in prohibited transactions by a service provider that the state retains. Providing investment advice for a fee has significant implications under the prohibited transaction rules, including a rigorous compliance framework. This is an area that has received little attention by the proponents of the legislation.

II. The Program Raises Significant Questions under the Federal Securities Laws.

Some of the legal issues facing the program are outlined in a memorandum from the law firm K&L Gates to the Board, dated March 17, 2016 ("K&L Gates Memo").[19] That memorandum states quite clearly that the legal questions "cannot be definitively answered at this point." The memorandum goes on to say that the Program could be "an 'investment company' under the Investment Company Act, and other aspects of the Program could be regulated under the federal securities laws. This would require registration with the SEC and significant reporting and disclosure obligations, which could make the Program considerably more expensive to operate."

Our own analysis of the federal securities laws, explained below and detailed in the attached Appendix, makes clear that the Program, as currently contemplated, would likely have to comply with many requirements of the federal securities laws. In particular, the Program could be required to register with the SEC as an investment company under the Investment Company Act of 1940, certain

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[16] 80 Fed. Reg. 72009.

[17] 81 Fed. Reg. 20946.

[18] *Ibid.*

[19] The K&L Gates Memo is available at www.treasurer.ca.gov/scib/analysis.pdf.

interests in the trust or reserve fund could be required to be registered with the SEC under the Securities Act of 1933, and the Board or other state officials could be required to register with the SEC as investment advisers under the Investment Advisers Act of 1940. As a result, there could be significant reporting and disclosure obligations associated with the Program, which could add considerable expense to the Program's operation. The legal basis for application of the federal securities laws and the important protections they afford to investors are explained below.

The Program, the trust and the reserve fund all could be required to register with the SEC. The Program meets the broad definition of "investment company" under the Investment Company Act. This is because the Program would use the trust and/or reserve fund, with the assistance of private employers, to invest, reinvest, and trade in securities with employees' IRA assets.[20] Each investment company is required to register with the SEC under the Investment Company Act unless it can rely on one of a number of available exemptions. No such exemption appears to exist for the Program, nor for the trust or the reserve fund, each of which also may need to register with the SEC as an investment company. Quite separately, interests in the trust or reserve fund that employee participants would hold would be required to be registered under the Securities Act unless an exemption is available. Our analysis indicates that no exemption from that registration or regulation would likely be available either.[21]

State officials could be required to register as investment advisers. The Board's selection and/or termination of an investment adviser to manage Program assets, or the direct management of Program assets by state employees, would require the Board or other state officials to register as investment advisers under the Investment Advisers Act of 1940. No exemption from registration appears to be available for the state officials.[22]

SEC regulation of the Program dramatically increases costs. The costs of the regulation described above can be significant. Federal securities laws would provide critical investor protections to

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[20] Under the Investment Company Act, an "investment company" includes any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of the issuer's total assets. Section 3(a)(1)(C) of the Investment Company Act. Private employers have an essential role under the program in collecting and remitting participant contributions.

[21] As discussed in more detail in the attached Appendix, the Program likely could not rely on the exclusion under Section 2(b) of the Investment Company Act for state entities. It also could not rely on the exclusion under Section 3(c)(11) of the Investment Company Act for certain employee benefit plans. Interests issued by the Program likely could not rely on the exemption from registration for securities of government entities provided by Section 3(a)(2) of the Securities Act.

[22] As discussed in more detail in the attached Appendix, the state officials that would serve as advisers to the Program would appear unable to meet the exclusion from the definition of adviser for state entities under Section 202(b) of the Advisers Act.

the Program,[23] but also would make the Program considerably more expensive to operate.[24] It is not clear whether these costs were considered in the feasibility analysis. Just a few examples of key investor protections provided by the federal securities laws include:

- Establishment of a board of directors that meets specified independence standards.
- Daily valuation of portfolio holdings, daily redeemability of mutual fund shares,[25] and satisfaction of certain investment limitations (*e.g.*, asset diversification and liquidity requirements).[26]
- Prohibitions on self-dealing, requirements regarding safekeeping (custody) of investment company assets, and detailed recordkeeping requirements.[27]
- Establishment of a compliance program and appointment of a chief compliance officer.[28]
- A written contract between the investment company and the persons responsible for

[23] The Investment Company Act seeks to prevent self-dealing by managers, inequitable or discriminatory treatment of shareholders, misleading or fraudulent methods of pricing or valuation, changes to investment objectives without shareholder consent, excessive leveraging, and inadequate or inaccurate disclosure.

[24] *See* K&L Gates Memo at p. 2.

[25] Under the Investment Company Act, a mutual fund cannot sell, redeem or repurchase its securities from investors except at a price based on the current net asset value of such security that is next computed after receipt of a tender of such security for redemption. *See* Rule 22c-1 under the Investment Company Act. The Investment Company Act prescribes how the current net asset value must be calculated for these redeemable securities. *See* Rule 2a-4 under the Investment Company Act (defining "current net asset value") and Section 2(a)(41) of the Investment Company Act (defining "value"). Mutual funds cannot delay the payment of shareholder redemptions for more than seven days. *See* Section 22(e) of the Investment Company Act.

[26] Section 18 of the Investment Company Act also provides that the securities issued by mutual funds must be voting stock, allowing mutual fund investors to vote on various matters, including the election of directors and the approval of investment advisory contracts. The SEC currently is considering amending certain investment company rules related to liquidity management that, if adopted, will add considerable expense to the operation of investment companies. *See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, 80 Fed. Reg. 62274 (Oct. 15, 2015).

[27] The investment company regulatory regime is complex, and we do not detail in this letter all of its requirements that could apply to the Program.

[28] *See* Rule 38a-1 under the Investment Company Act.

making investment decisions for the investment company.[29] Those persons would have to register with the SEC as investment advisers under the Advisers Act and would be subject to specific disclosure requirements and substantive regulations (*e.g.*, insider trading restrictions) under the Advisers Act.[30]

- Registration of the public offer and sale of interests in the trust or reserve fund to be owned by the employee participants. That registration process calls for a detailed set of disclosures about the business and operations of the company.[31]

- The trust or reserve fund also would be required to, among other things, prepare and provide to the employees semi-annual and audited annual financial reports, disclose publicly their portfolio holdings on a periodic basis, and disclose publicly how the proxies attached to their portfolio holdings were voted.

III. Financial Risks to the Program Have Been Dramatically Understated.

Earlier this year, the Institute provided extensive comment on the Program to the Secure Choice Board in connection with its consideration of a report prepared by Overture Financial LLC that analyzed the financial feasibility of the Program.[32] As explained in the attached letter to California State Treasurer and Chairman of the Secure Choice Board John Chiang ("March 24 Letter"),[33] the report did not adequately consider financial and legal risks that call into question the feasibility of the Program.

The Program raises several financial risks to the taxpayers of California, to Program participants, and to service providers. The most significant of these are the share of covered employees

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[29] *See* Section 15 of the Investment Company Act, which imposes substantive requirements on the terms of the written contract between an investment company and its investment adviser, and calls for, among other things, the approval of the contract by the board of directors and shareholders of the investment company.

[30] Investment advisers are required to file a Form ADV with the SEC and may be required to provide certain public disclosures to clients.

[31] Registration under the Investment Company Act and Securities Act involves the completion and filing of a registration statement with the SEC for review and comment by the SEC staff. Funds generally are required to provide their shareholders with detailed information about, among other things, the costs of investing in the company, its principal investment strategies and principal risk factors, as well as information about the investment adviser to the company.

[32] The report is dated March 17, 2016 and is available at www.treasurer.ca.gov/scib/report.pdf.

[33] *See* March 24, 2016 letter from the Institute to The Honorable John Chiang, California State Treasurer ("March 24 Letter"), available at www.treasurer.ca.gov/scib/comments/blass.pdf.

that choose not to participate (opt-out rates), contribution rates among participants, withdrawal and turnover activity, and administrative costs. All four risk factors could affect the financial viability of the Program. Additionally, the investment structures contemplated under the Program raise additional risks and associated costs.

Opt-out rates may be higher than anticipated. The financial viability of retirement programs, like the California Secure Choice Program, depends on the number of covered employees that will continue to participate after being automatically enrolled. High opt-out rates could significantly increase the cost of running the Program.

Assumptions about opt-out rates quite often are overly optimistic, in part because they typically are based on findings derived from private-sector experience. It is quite likely, however, that automatic enrollment in state retirement programs will not elicit the participation rates produced by automatic enrollment in voluntary private-sector retirement plans.

Plan design and workforce demographics are significant factors that affect opt-out rates, as discussed in the letter to the Board.[34] The workers in California not currently offered a retirement plan at their current employer are younger, have lower incomes, and are more likely to work part-time than workers who are offered a plan.[35] All three characteristics of these workers reduce the likelihood of their participating in a savings plan like the Program.

Opt-out rates not only may be high, but could be distributed across employers in a way that could increase costs of maintaining the Program. The Program will likely incur costs for each employee who participates and for each employer. The fewer the number of employees who participate per employer, the higher the per-account operating costs will be for the Program. Two examples are provided in the accompanying March 24 Letter.[36]

Contribution rates may be lower than expected. Contribution rates will have a significant impact on the ultimate cost of running the Program.[37] Low levels of contributions will lead to accounts with small balances. A plan with small average account balances will be more costly to operate than a plan with the same overall level of assets but larger average account balances.

Given that the wage and salary earnings for workers not currently covered by a retirement plan tend to be quite low, the amounts that workers are likely to contribute also will be modest.

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[34] March 24 Letter at pp. 4–14.

[35] *See* Figure 2 in the March 24 Letter at p. 10.

[36] March 24 Letter at pp. 12–14.

[37] March 24 Letter at pp. 15–17.

Participating workers with low levels of earnings likely would make small contributions and have small account balances because of the other demands on their financial resources. In this respect, one-fifth of California workers who do not have retirement plans at their current employers have annual earnings of $9,624 or less, and half have earnings of $23,009 or less.[38] Even if the legislation were to focus on the 57 percent of eligible workers who are full-year, full time workers, one-fifth of those workers have earnings of $20,151 or less and half have earnings of $33,749 or less.[39] These earnings levels are not likely to support contribution rates of the sort necessary to ensure the self-sustaining economic viability of the Program.

Income levels play an important determining factor in understanding retirement savings behavior. The data suggest that nationwide about three-quarters of private-sector workers without retirement plan coverage may be focused on other savings goals or experiencing other financial stresses.[40] The policy rationale underlying state initiatives, like SB 1234, does not give adequate consideration to the fact that retirement savings is not the beginning of the financial difficulties for many of these individuals. It also does not give due regard to the important role that Social Security plays in replacing earnings for U.S. retirees, particularly workers with lower earnings, who get high replacement rates from Social Security.[41]

Withdrawal and turnover rates could be high, keeping average account balances low and costs per account high. There are several variables that would affect withdrawal activity and account turnover: (1) access to account balances in times of financial hardship; (2) behavior at job change of participants in a mandatory automatic enrollment program; (3) IRA rules which permit individuals to change financial services providers at any time; and (4) realization by participants that a private-sector IRA may offer a more attractive investment opportunity.

All of these factors will affect the size of the average account in the Program. Program participants, for example, may realize that they can find a more attractive retirement savings option in the private sector, with additional investment choice, flexibility, and lower-cost options. At year-end 2014, more than 90 percent of IRA equity mutual fund assets were in equity mutual funds with operating expenses of less than 1.0 percent, including 40 percent with operating expenses of less than

[38] *See* Figure 8 in the March 24 Letter at p. 17.

[39] *Ibid*.

[40] March 24 Letter at pp. 25–27.

[41] The Congressional Budget Office reports estimated replacement rates from scheduled Social Security payments, and Social Security replaces a higher percentage of pre-retirement earnings for workers in lower-earning households than it does for workers in higher-earning households. See Congressional Budget Office, *CBO's 2015 Long-Term Projections for Social Security: Additional Information* (December 2015), available at www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51047-SSUpdate.pdf.

0.50 percent.[42] All of these factors could be expected to lead to high levels of turnover and withdrawal activity and keep average account sizes small.

Administrative costs likely will be higher than estimated. Implementing and operating the Program will result in many costs in addition to those described above. These include enforcement costs, additional administrative costs related to invalid Social Security numbers, costs relating to the contribution patterns of part-year and seasonal workers, and the full costs of developing and delivering participant education materials, communication channels, and necessary reporting systems. These costs will create pressure on California to find revenues to pay significant start-up and ongoing administrative costs—particularly if assumptions about participation, contribution, and withdrawal rates do not meet expectations.

The bill provides that funding for start-up and first year administrative costs may be appropriated from the state's General Fund, and that the Board must repay the amount of this General Fund loan, plus interest. After the first year, the Program is intended to be self-sustaining, with all administrative costs paid by funds in the trust and capped at 1 percent of total Program funds annually. But it is unclear whether the Program will generate sufficient fee-income to repay the General Fund loan and to cover ongoing administrative costs, without exceeding the 1 percent cap, which is already higher than the average fee that IRA investors pay when investing in mutual funds.

Contemplated investment structures raise yet more risk. Recent reporting suggests that there remains great uncertainty about how the Program will be managed. Many of the options the Board is considering raise substantial risks to the State of California.[43]

The Board, for example, is considering a "pooled IRA with reserve fund," which would be a state-issued special purpose retirement savings bond, with a variable interest rate set by the Board and a "soft guarantee" to reduce, but not prevent, losses. According to the report's description of the bond, in years when the investment fund has a "surplus return," the surplus would be used to cover shortfalls during negative return years. This "soft guarantee" creates the very real risk that a sustained negative market environment will exhaust any "surplus" earnings withheld from participants. In such circumstances, the Board will be faced with very unattractive options—to fund distributions from new contributions, or to reduce participants' account balances to cover investment losses, or to seek a

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[42] *See* Figure 9 in the March 24 Letter at p. 19. Furthermore, it also is clear that IRA investors pay below-average fees for their mutual funds. *See* "Statement of the Investment Company Institute, Brian Reid, Chief Economist, Hearing on 'Restricting Access to Financial Advice: Evaluating the Costs and Consequences for Working Families and Retirees,' Subcommittee on Health, Employment, Labor, and Pensions Committee on Education and the Workforce, United States House of Representatives" (June 17, 2015), at pp. 7–8; available at www.ici.org/pdf/15_house_advice.pdf.

[43] *See* www.treasurer.ca.gov/scib/staff/2015/20151207/5.pdf; *see also* calpensions.com/2015/12/14/state-savings-plan-may-have-no-firm-guarantee/.

bailout from California taxpayers to cover the funding deficit created by the "soft guarantee."[44] In other words, California taxpayers may well need to come to the rescue of the Program.

Another option under consideration is a variable annuity with a guaranteed minimum withdrawal benefit, offered through a private insurance product. Covering a withdrawal benefit through private insurance also comes with risk, as the cost of doing so—even if such coverage was available—has been estimated by at least one state to be from 100 to 200 basis points per year.[45] These costs have not been factored into the financial feasibility of the Program.

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As detailed above, the Program faces unknown and potentially significant costs and risks not only to California taxpayers but also to Program participants. If the costs of running the Program exceed expectations, any earnings and potentially the principal associated with employee contributions will be eroded, leaving those employees that rely on the Program for portions of their retirement income simply out of luck. For all the reasons discussed above, it simply would be imprudent to move forward with the Program without much further study and far greater assurance that its costs are fully understood and accounted for. We therefore strongly recommend that you to undertake a careful, critical examination of the costs and legal risks inherent in establishing and administering the Program before signing this consequential piece of legislation.

The Institute agrees with the importance of promoting retirement security for American workers. We share the goal of increasing access to payroll-deduction savings opportunities, but believe there are other more targeted changes at the national level that will be more effective at achieving this goal.[46] In our view, policies that cooperate with, rather than coerce, employers, who best know the

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[44] With respect to the "reserve fund" approach, the K&L Gates Memo notes other important issues. Because the reserve fund would involve holding back a portion of the trust earnings in "good" years for allocation to individual accounts in "bad" years, the memorandum explains that: "[S]ome early participants and short term participants may not benefit from the reserve and could even experience reduced returns in good market years when 'excess' returns are funneled to the reserve fund. Others, who participate during bad years, may benefit from the reserve accumulated by previous investors. In addition, if the reserve fund becomes sizable, the Board and the State Government may face pressure to 'break open' the reserve for immediate allocation or, conceivably, some State purpose outside the Secure Choice Program." *See* www.treasurer.ca.gov/scib/analysis.pdf.

[45] *See* www.osc.ct.gov/crsb/docs/finalreport/CRSB_January_1_Report.pdf.

[46] For a description of such targeted changes, *see* letter from Investment Company Institute to U.S. Department of Labor, dated January 19, 2016; available at www.dol.gov/ebsa/pdf/1210-AB71-00062.pdf.

demographics and needs of their workers, present far more efficient and effective solutions for expanding workplace retirement plan coverage.

If you need additional information or you have questions regarding our letter, please do not hesitate to contact me at (202) 326-5901 or paul.stevens@ici.org. We welcome the opportunity to discuss these comments further or to provide additional information to you and your staff as you work on this important issue.

Sincerely,

Paul Schott Stevens
President & CEO
Investment Company Institute

Attachments:
- Appendix (July 27, 2016 memorandum from Stradley Ronon on federal securities law implications)
- March 24 Letter

Stradley Ronon Stevens & Young, LLP
1250 Connecticut Avenue, N.W., Suite 500
Washington, DC 20036-2652
202.822.9611
www.stradley.com

TO: David Blass
Dorothy Donohue
Sarah Bessin

DATE: July 27, 2016

FROM: Alison M. Fuller
Nicole Simon

SUBJECT: The Implications of the California Secure Choice Retirement Savings Program (the "CA Program") under the Federal Securities Laws

You have asked us to analyze the CA Program under the federal securities laws, including the status of the CA Program as an "investment company" under the Investment Company Act of 1940 (the "1940 Act"). As explained below, we believe that the CA Program implicates the federal securities laws through the potential offer and sale of unregistered securities and the creation of one or more unregistered investment companies that implicate the public policy concerns underlying the 1940 Act. The CA Program may not be eligible to rely on the regulatory exclusions for State Entities, as that term is defined below.

BACKGROUND ON STATE MANDATED PRIVATE SECTOR RETIREMENT PROGRAMS

General Background. Recently, a number of states have moved forward with programs designed to cause non-governmental employees to save money for retirement.[1] On September 28, 2012, California Governor Jerry Brown signed into law

1 For example, in addition to California, other states that have either proposed or adopted implementing legislation establishing state-run retirement programs in some form include Arizona (Senate Bill No. 1332, Arizona Secure Choice Retirement Savings Trust Act), Colorado (House Bill No. 16-1403, Colorado Secure Savings Plan Act), Connecticut (House Bill No. 5591, An Act Creating the Connecticut Retirement Security Program), Illinois (Senate Bill No. 2758/Public Act 098-1150, Illinois Secure Choice Savings Program Act), Indiana (House Bill No. 1349, Hoosier Employee Retirement Options Portal), Kentucky (House Bill No. 261, An Act Relating to Small Business Deferred Compensation), Louisiana (Senate Bill No. 53, Louisiana Secure

the California Secure Choice Retirement Savings Trust Act (the "CSCA"), which established the California Secure Choice Retirement Savings Investment Board (the "CA Board") to administer the CA Program.

As enacted in 2012, the CSCA required the CA Board to conduct a study to determine whether the legal and practical conditions for implementation of the CA Program could be met.[2] The CA Board hired Overture Financial LLC ("Overture") to conduct a study on program design, market analysis, and financial feasibility. In March 2016, Overture issued its report which contains information about the likely structure of the CA Program that we analyze in this memorandum (the "Overture Report").[3] Further legislative action is necessary to implement the CA Program and a new Senate Bill No. 1234 has been introduced to do so.[4]

Choice Savings Plan), Maryland (House Bill No. 1378/Senate Bill No. 1007, Maryland Small Business Retirement Savings Program and Trust), Massachusetts (Senate Bill No. 1637, An Act Providing Retirement Options for Private Sector Employees), New Jersey (Assembly Bill Nos. 4275, 1341 – New Jersey Small Business Retirement Marketplace Act), New York (Assembly Bill No. 8332/Senate Bill No. 6045, New York State Secure Choice Savings Program Act), Oregon (House Bill 2960, A Bill for an Act Relating to Retirement Investments and Declaring an Emergency), Rhode Island (House Bill No. 7219, Relating to State Affairs and Government – Private Employer IRA Program), and Washington (Senate Bill No. 5826, An Act Relating to Creating the Washington Small Business Retirement Marketplace). In addition, a number of other states have proposed or enacted bills calling for feasibility studies regarding state-run retirement programs.

2 In 2013, the CA Board issued a Request for Information with respect to the CA Program to which the Investment Company Institute ("ICI") responded. *See* Letter from Ms. Dorothy M. Donohue and Mr. David M. Abbey (ICI) to Mr. Grant Boyken (CA Board), dated November 15, 2013, *available at* www.treasurer.ca.gov/scib/rfi/ici.pdf.

3 *Final Report to the California Secure Choice Retirement Savings Investment Board by Overture Financial LLC* (Mar. 17, 2016), *available at* http://www.treasurer.ca.gov/scib/report.pdf. The Overture Report was intended to be "an actionable document that can contribute to the successful launch of the [CA Program]." The CA Board also hired K&L Gates, LLP ("K&L Gates") to provide legal services and analysis with respect to the CA Program. Memorandum from David E. Morse (K&L Gates) to the CA Board (Mar. 17, 2016), *available at* http://www.treasurer.ca.gov/scib/analysis.pdf ("K&L Gates Memo").

4 California Senate Bill No. 1234 (2015-2016 Regular Session) (introduced in February 2016 and amended on April 6, 2016, May 31, 2016 and June 15, 2016).

Senate Bill No. 1234 was proposed in February 2016 and it continues to be further amended (including as recently as June 15, 2016). In its currently proposed form, Senate Bill No. 1234 sets forth the basic framework regarding the CA Program, but leaves many important details open for later determination by the CA Board, including those that are important to an analysis of the CA Program under the federal securities laws. Additional detail is available in the Overture Report and the related legal analysis memorandum from K&L Gates, which discuss various alternative options, none of which have been codified in the California statutes or regulations. The lack of concrete detail prevents a definitive analysis of the CA Program.

Automatic Participation. The CA Program, in its currently proposed form, would cause the employees of many private businesses in California to automatically contribute a percentage of their salary to a tax advantaged, individual retirement account ("IRA"). Specifically, the CSCA would require "eligible employers"[5] in the state of California to provide a payroll deposit retirement savings arrangement whereby the automatic deduction would take place.

An employee who does not wish to participate in the CA Program would need to affirmatively opt out by completing an opt out form during the enrollment period.[6] At least once every two years, employers would be required to designate an open enrollment period during which all eligible employees (including those who previously opted out of the CA Program) would be automatically enrolled in the CA Program unless the employees again elect to opt out by submitting new opt out forms.[7] Thus, an employee who wishes not to participate in the CA Program will need to complete and submit a form at least once every two years in order to maintain the status quo.

The legislative history of the CA Program shows that it is intentionally structured to capture as many employees as possible regardless of their financial ability to participate in the CA Program.[8] According to the Overture Report, it is estimated

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5 For this purpose, "eligible employer" would mean a person or entity engaged in a business, industry, profession, trade, or other enterprise in the state, whether for profit or not for profit, excluding the federal government, the state, any county, any municipal corporation, or any of the state's units or instrumentalities, that has five or more employees and that satisfies the requirements to establish or participate in a payroll deposit retirement savings arrangement. Cal. Gov. Code § 100000(d) (Jan. 1, 2013)(proposed to be recodified at § 100000(d)(1)).

6 Cal. Gov. Code § 100014(e) (Jan. 1, 2013) and § 100032(f) (Jan. 1, 2013)(proposed to be recodified at § 100032(g)).

7 Cal. Gov. Code § 10032(f) (Jan. 1, 2013) (proposed to be recodified at § 100032(g)).

8 The Overture Report considered alternatives but ultimately did not recommend them. Such other alternatives were: (1) an opt in system, whereby employees would

that 6.8 million workers in the state of California are potentially eligible for the CA Program, and the median wage and salary income for this group is $23,000. Because the CA Program has no minimum income threshold, an employee making only $23,000 annually (or less) will be subject to the automatic payroll deduction unless he or she takes affirmative steps to opt out of the CA Program (and repeats these steps during every subsequent enrollment period).

Contribution Amounts. Under the CSCA, the percentage to be contributed by each employee would initially be set at three percent of the employee's annual salary or wages.[9] The CA Board may adjust this contribution amount to an amount between two and five percent of the employee's annual salary or wages. The CSCA does not provide guidance regarding the CA Board's determination of contribution amounts (*e.g.*, no required process for determining amounts, and no prescribed factors to be considered). Additionally, the CA Board is permitted (and expected) to implement automatic escalation of employee contributions up to eight percent of the employee's annual salary or wages (up to a one percent increase per year), similarly with no prescribed process or enumerated factors to be considered.[10]

Contribution Mechanism. Under the CSCA, the private sector employers would be called upon to deduct from participating employees' paychecks the contributions of the participating employees. The private employers would then remit those amounts to the employees' IRAs, as maintained within the CA Program, on their behalf. Significantly, the CSCA contains no provision for state oversight of employers to ensure that these private employers (which can include, for example, sole proprietorships) remit proper amounts in a timely manner (or at all).[11]

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be required to take action to opt in to the CA Program; and (2) an active choice system, whereby employees would be forced to make a decision about whether or not to participate.

9 Cal. Gov. Code § 100032(h) and (i)(Jan. 1, 2013)(proposed to be recodified at § 100032 (i) and (j), respectively).

10 Cal. Gov. Code § 100032(k), as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session). As currently proposed, participants would be able to adjust their contribution percentage rates within the opt out structure.

11 The CA Program clearly contemplates the involvement of small private employers, including those with ten or fewer employees. *See* Cal. Gov. Code § 100046 (a)(10), as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session). It is not clear how those employers can be expected to calculate proper amounts or ensure that they are remitted in a timely fashion, a burden which is particularly heightened for small employers when employees are paid weekly or bi-weekly. Senate Bill 1234 proposes to amend the California Welfare and Institutions Code to

Furthermore, there are currently no provisions designed to protect participant assets while they are in the possession of private employers. The CSCA contains no provisions governing the custody of funds during that transition period, or any mechanism for ensuring that employers remit assets in accordance with the CSCA.[12] It is proposed that the CSCA contain a provision requiring the CA Program to be structured in a manner to meet the criteria of a yet-to-be-finalized regulation issued by the Department of Labor ("DOL"). That DOL regulation, as proposed, would require that the State assume "responsibility for the security of payroll deductions and employee savings."[13] The proposal contains no further detail. Thus, it is not clear how California will ultimately implement the requirement, and interpret what its responsibility for "the security of payroll deductions and employee savings" means.[14]

The risks introduced by the involvement of private employers are particularly significant in the context of an opt out program such as the CA Program, because employees may not assess the trustworthiness or financial wherewithal of their

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require the state to perform or assure the performance of certain CA Program-related tasks by employers in the limited context of in-home supportive services. Those provisions do not apply with respect to all employers. *See* Section 12302.2 of the California Welfare and Institutions Code, as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session). By contrast, private employers subject to the Employee Retirement Income Security Act of 1974 ("ERISA") are subject to strict rules regarding the transfer of employee contributions to plan trusts. *See* 29 C.F.R. § 2510.3-102.

12 While the CSCA does not provide for accountability to participants, it provides some liability protection for employers. *See* Cal. Gov. Code § 100034 (d), as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session) ("An employer shall not have civil liability, and no cause of action shall arise against an employer, for acting pursuant to the regulations prescribed by the board defining the roles and responsibilities of employers that have a payroll deposit retirement savings arrangement to allow employee participation in the program.").

13 Savings Arrangements Established by States for Non-Governmental Employees, 80 Fed. Reg. 72006 (Nov. 18, 2015)(Proposed Rule). The DOL proposal describes circumstances in which a payroll deduction savings program would not give rise to an employee pension benefit plan under ERISA.

14 The state may have an interest in crafting a provision that would minimize its potential liability. There may a difference between safeguarding amounts actually deducted from the employees' paychecks and ensuring that the deductions are calculated and deducted properly in the first place, the latter of which the DOL proposal does not address.

employers prior to being automatically enrolled into the CA Program and becoming subject to the risks introduced by the involvement of their private employers. While the CA Program claims to limit employer interaction and transactions with employees "to the extent feasible," the tasks for which private employers will remain responsible are critical aspects of the CA Program, and areas that typically receive heightened attention under the federal securities laws (*e.g.*, custody, conflicts of interest).

Pooling of Contribution Amounts. It appears that the IRA assets of all of the participating employees would be deposited in the California Secure Choice Retirement Savings Trust (the "Trust"), which would be established under the CSCA. The assets in the Trust would be invested under the supervision of the CA Board according to one of two investment approaches that were recommended by the Overture Report (but have not yet been finalized): an asset allocation investment approach or a reserve fund bond investment approach, each described below. For the reserve fund bond investment approach, the Overture Report recommended the creation of a special purpose pooled vehicle which would pool participant assets and in exchange for participant assets would issue bonds to participants, as described below. The decision of which approach to follow is yet to be made by the CA Board in establishing the CA Program.

Asset Allocation Investment Approach. Under the first investment approach ("asset allocation strategy"), the CA Board would make available to employees a range of asset allocation investment choices. It is not clear how the CA Board would implement this approach. The Overture Report suggests the use of either "target date" mutual funds or separately managed accounts. The Overture Report recommends that if the CA Board chooses to offer the asset allocation strategy, it should create funds as proprietary investment vehicles (either as the target date funds or as the underlying funds to be used as building blocks within the managed account approach). As K&L Gates pointed out, the target date funds used in the asset allocation strategy could be registered investment companies (off-the-shelf) or unregistered vehicles (custom or white label or both), depending on the preference of the CA Board.[15]

Under the target date fund approach, the CA Program would make available a number of target date funds with the intent of providing investment options to various age groups and risk profiles (conservative, moderate and aggressive). Employee assets would be pooled within the target date funds, which would be managed by an investment manager and invested in stocks, bonds, money market instruments and other investments. Participants would be defaulted to the target date fund that corresponds to their expected retirement age based on their date of birth.

Under the managed account approach, each participant would have his or her own IRA managed by an investment manager. The investment manager would invest

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15 K&L Gates Memo, *supra* note 3.

the managed accounts into underlying stock funds, bond funds, money market funds and potentially other investments. For each account, the investment manager, aided by software, would allocate contributions across various investments and re-balance the portfolio according to the strategy selected for that account. The CA Board would set the default strategy and the range of choices for participants. The CSCA does not establish whether or to what degree this investment advice would be individualized to the particular participant, or whether participants would be allowed to impose reasonable restrictions on the management of his or her managed account.

Reserve Fund Bond Investment Approach. Under the second investment approach outlined by the Overture Report ("reserve fund bond strategy"), participants would invest their IRA assets in exchange for variable interest rate bonds that would be redeemable at par value. The assets would be held by a special purpose legal entity (the "Reserve Fund") that would be established to receive on its balance sheet all the contributions of participants to be managed in a single investment pool. The Overture Report specifically recommended this structure to avoid the Reserve Fund being regulated as a mutual fund under the 1940 Act, and noted that the structure attempts to replicate the collective risk-sharing aspect of cash balance plans in the defined contribution context with no employer or state-backed guarantee. The Overture Report contemplates that an existing public authority would be designated to serve as the Reserve Fund or that a new statewide public authority would be established.

Under the reserve fund bond strategy, the Reserve Fund would invest the assets with direction and oversight by the CA Board, advice from investment consultants, and implementation by one or more investment managers. The CA Board would establish a policy whereby the bonds would provide a smoothed return to participants regardless of the market performance of the underlying Reserve Fund's assets. The CSCA provides no mechanism for funding the obligations payable under the bonds, should the Reserve Fund be depleted. Nor are there specific protections in place to prevent the California state government from "breaking open" the Reserve Fund.[16] The Overture Report acknowledged that the Reserve Fund approach would result in "the first generation sacrific[ing] some returns to build [the] reserve," because "[i]n the early years some of the available returns will be diverted towards establishing the desired reserve level and will not flow into credits to participants."

Variable Annuities. The Overture Report also recommends that the CA Board consider a variable annuity with a guaranteed minimum withdrawal benefit "as a complementary offering" two to three years after the launch of the CA Program. It

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[16] In its analysis of the CA Program, K&L Gates acknowledged that "if the [R]eserve [F]und becomes sizable, the [CA] Board and the state government may face pressure to 'break open' the reserve for immediate allocation or, conceivably, some state purpose outside the [CA Program]." K&L Gates Memo, *supra* note 3.

would be a third-party insurance product that would offer income protection beginning ten years prior to retirement. Under this offering, the insurance company would guarantee a minimum lifetime retirement income (with no cost of living adjustment) of five percent of the amount invested, even if the account value goes to zero. Contributions would be invested following a 60 percent to 40 percent stocks-to-bonds asset allocation, and the insurance company would charge an annual fee of one percent of assets (on top of investment fees) for the guarantee. If the net investment results are favorable, the guarantee can be "stepped up" (although details regarding the step up have not been provided).

The Role of the CA Board. The CA Board would be comprised of nine members, only one of whom would be required to have any retirement savings or investment expertise. Specifically, the CA Board will be comprised of: the Treasurer; the Director of Finance, or his or her designee; the Controller; an individual with retirement savings and investment expertise appointed by the Senate Committee on Rules; an employee representative appointed by the Speaker of the Assembly; and four directors appointed by the Governor (a small business representative, a public member, and two additional members).[17] These individuals would be fiduciaries to the CA Program and would be responsible for (among other things) setting its investment policy, making investment policy decisions, including asset allocation and investment options, risk management and oversight, and the appointment of an investment management entity or entities.[18] According to state regulation, the CA Board members "shall serve without compensation," although some will be compensated for their general positions with the state (*e.g.*, the Treasurer).[19] Under the CSCA, the CA Board will provide investment management advice to the CA Program, indirectly through the appointment of one or more investment managers or through direct management of CA Program assets by the Treasurer. Specifically, the CSCA (as proposed to be amended) states, "Monies in the program may be invested or reinvested by the Treasurer or may be invested in whole or in part under contract with the board of a California public retirement system or private money managers, or both, as determined by the [CA Board]."[20]

Important Program Elements Remain Unknown. As noted above, many of the structural details, operational elements and other aspects of the CA Program are not set

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17 Cal. Gov. Code § 100002(a)(1) (Jan. 1, 2013).

18 Cal. Gov. Code § 100002(e) (Jan. 1, 2013), as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session).

19 Cal. Gov. Code § 100002(b) (Jan. 1, 2013).

20 Cal. Gov. Code § 100004, as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session).

forth in the CSCA, either in its current form or as proposed to be amended by California Senate Bill No. 1234. For instance, the specific structure of the CA Program will be left entirely to the CA Board's discretion rather than being solidified in state legislation.[21]

Numerous elements of the CA Program remain unknown. For instance, the CSCA sets forth no investment limitations. There are no restrictions on the types of investments that may be purchased within the CA Program or limitations on leverage. The original draft of the CSCA had included investment and leverage limitations, but they are explicitly proposed to be deleted by California Senate Bill No. 1234. Although the CSCA does require the appointment to the CA Board of one individual with "retirement savings and investment expertise," the CSCA does not establish what level of expertise would be sufficient, nor does it otherwise call for any particular level of investment expertise or education on the part of the remaining eight members of the CA Board or others who could be called upon to make investment decisions for the CA Program.[22]

It also appears that many important operational aspects of the CA Program are left unaddressed in the CSCA, in its current form and as proposed to be amended, including arrangements surrounding custody, recordkeeping, disclosure, and affiliated transactions. There is no explanation in either the CSCA or in the Overture Report of how Trust assets will be custodied or who may serve as custodian. Furthermore, the CSCA does not fully establish or address the rights of participants in connection with the loss or misappropriation of assets. Assets could be lost or stolen through faulty or improper recordkeeping and accounting by those who operate the CA Program, including by the private employers.

The CSCA does not contain provisions concerning participant assets that are in the possession of the private employers. While the CA Program seeks to alleviate the burden on private employers, the employers will be responsible for certain key tasks such as the collection and remittance of employee contributions to the CA Program. The CSCA contains no provisions governing protection of participant assets during that

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21 Cal. Gov. Code § 100046, as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session).

22 Proposed amendments to the CSCA, however, would make the CA Board and the program administrator and staff fiduciaries with respect to the CA Program, which underscores their central importance and calls into question whether it is appropriate for any such persons to be laymen without any level of retirement savings and investment expertise. *See* Cal. Gov. Code § 100002(d)(Jan. 1, 2013), as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session).

transition period, or any mechanism for ensuring that employers remit assets in accordance with the CSCA.

There are no provisions in the CSCA regarding any recordkeeping requirements. The Overture Report discusses various options for recordkeeping arrangements, but the considerations are generally limited to operational considerations such as lowering costs and increasing the efficiency of communications to employers rather than investor protection provisions similar to the recordkeeping requirements of the 1940 Act.

The CSCA disclosure requirements are also limited. They are focused on disclosures regarding the CA Program in general (*e.g.*, disclosures regarding "the mechanics of how to make contributions to the program," "the process for withdrawal of retirement savings," and articulation of the fact that "the program fund is not guaranteed by the State of California," among others).[23] They do not include disclosures regarding underlying investments. The CSCA does not include a single provision regarding the disclosure of fees to participants. Nor do the disclosure requirements require an explanation of the circumstances, if any, in which the state could appropriate the assets of the CA Program, which would be meaningful information for participants in determining whether to opt out of the CA Program.

As explained below, those regulatory gaps in the CSCA (and the proposed amendments) create risks to participants that the 1940 Act and the federal securities laws generally were designed to address.

IMPLICATIONS UNDER THE FEDERAL SECURITIES LAWS

Introduction. The CA Program implicates the investor protection concerns underlying the federal securities laws, particularly the 1940 Act and the Investment Advisers Act of 1940 (the "Advisers Act"). The public offer and sale of interests in the CA Program would not be subject to the investor protections granted by the federal securities laws. In particular, the CA Program entails the creation of one or more issuers of securities that would meet the definition of an "investment company" and present to the public the very risks that the 1940 Act was designed to address.

Below we explain how the CA Program, in its current form and as proposed to be amended, implicates the 1940 Act and why the Securities and Exchange Commission ("SEC") and its staff should be very cautious about providing any regulatory relief. Construing the CA Program as consistent with any exemption or exclusion from regulation would be a meaningful departure from prior relief, leaving participants exposed to material risks due to, among other things, the role to be played by private sector employers in facilitating the CA Program. The current lack of factual clarity

[23] Cal. Gov. Code § 100014, as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session).

surrounding the CA Program also casts doubts on the appropriateness of providing any relief.

1940 Act Definition of an Investment Company. The 1940 Act contains a broad definition of the term "investment company," in order to allow the SEC to further the public policy goals underlying the statute. The CA Program meets that definition. Section 3(a)(1)(C) of the 1940 Act defines an "investment company" as including any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets.[24]

Under the 1940 Act, an issuer may exist even though it is not formally organized as a separate legal entity.[25] The 1940 Act provides for a broad definition of the term "issuer," "in order to control [an investment enterprise] regardless of the legal form or structure of the investment enterprise."[26] Section 2(a)(22) of the 1940 Act defines the term "issuer" to mean "every *person* who issues or proposes to issue any security, or has outstanding any security which it has issued" (emphasis added). Section 2(a)(28) of the 1940 Act defines the term "person" to mean "a natural person or a *company*" (emphasis added). Section 2(a)(8) of the 1940 Act, in turn, defines the term "company" to mean "a corporation, a partnership, an association … a trust, a fund, or *any organized group of persons whether incorporated or not*" (emphasis added).

The courts and the SEC have interpreted the concept of an "organized group of persons" broadly for purposes of determining whether unregistered investment companies exist in a number of different circumstances. For example, the SEC determined, and the United States Court of Appeals for the Third Circuit upheld, that variable annuity contracts, together with the proceeds of their payments, constitute a trust, a fund, and an organized group of persons, and thus an issuer under the 1940 Act, separate and apart from the relevant insurance company.[27] In addressing the issue, the

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[24] *See also* section 3(a)(1)(A) of the 1940 Act, which defines an investment company as including any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.

[25] In Comdisco, Inc., SEC No-Action Letter (pub. avail. Oct. 25, 2000), the SEC staff applied and explained the broad definition of the term "issuer" in the 1940 Act. *Robert H. Rosenblum, Investment Company Determination Under The 1940 Act Exemptions and Exceptions, 5-25 (2003)* also provides a valuable explanation of the SEC and staff's interpretation of the terms "issuer" and "investment company."

[26] *Prudential Insurance Company of America v. SEC*, 326 F2d 383, 387 (3d Cir. 1964), *cert denied*, 377 U.S. 953 (1964).

[27] *Id*.

court "start[ed] with the premise that securities legislation must be broadly construed in order to insure the investing public a full measure of protection."[28] The SEC has determined that discretionary investment advisory programs for individual clients are organized and operated so as to create an unregistered investment company when there is no individualization of investment advice and services.[29]

Employee Interests in the CA Program Would be Securities. Employee interests in the CA Program would constitute securities under section 2(a)(36) of the 1940 Act, and would similarly constitute securities under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act").[30] In particular, each statute defines the term security to include an "investment contract." Consistent with other interpretations by the SEC staff, employee interests in the CA Program would be investment contracts.[31]

The CA Program Entails One or More Issuers Engaged in the Business of an Investment Company. Several issuers of the employees' interests in the CA Program can be identified within the various proposed structures for the CA Program. As noted above,

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28 *Id.*, citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

29 *See* Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15098, at 15100 (Mar. 31, 1997); Rule 3a-4 Reproposing Release, 1940 Act Release No. 21260, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P85,646 (July 27, 1995).

30 The definitions of the term "security" in the 1933 Act and 1934 Act are virtually identical to one another and are very similar to the definition in section 2(a)(36) of the 1940 Act.

31 *See, e.g.*, ICMA Retirement Corporation, SEC No-Action Letter (pub. avail. Mar. 4, 1974)(wherein the SEC staff stated, "[I]t is our view that the deferred compensation agreements which provide for participation in the Plan are securities as defined in Section 2(1) of the Securities Act of 1933, since they constitute 'evidences of indebtedness' or 'investment contracts' issued to participating employees of each employer. The Supreme Court has broadly defined 'investment contract' to include any arrangement which involves 'an investment of money in a common enterprise with profits to come solely from the efforts of others.'"(citing *SEC v. W.J. Howey, Co.*, 328 U.S. 293 (1946))). *See also SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 477 (5th Cir. 1974), wherein the Fifth Circuit stated that the Howey test consists of three elements: "First, that there is an investment of money; second, that the scheme in which an investment is made functions as a common enterprise; and third, that under that scheme, profits are derived solely from the efforts of individuals other than the investors." The interests of employees in the CA Program meet each of those elements.

the definition of the term "issuer" in the 1940 Act is very broad, and includes any organized group of persons whether incorporated or not.

Under the asset allocation strategy, the Trust appears to be an issuer. Under the reserve fund bond strategy, the Reserve Fund would be an issuer.[32] In addition, the collection and remittance of participant contributions is an essential component of the CA Program which would appear to include the private sector employers and potentially, the employees, as part of the "group of organized persons" comprising an issuer under the 1940 Act.[33] Furthermore, the use of managed accounts by the CA Program could similarly entail the creation of unregistered investment companies, as programs that provide discretionary investment advisory services lacking appropriate individualization of advice and services.

The CA Program, including the Trust and the Reserve Fund and with the assistance of private employers, appears to have the sole business of investing, reinvesting and trading in the securities acquired with the employees' IRA assets. Persons empowered to make (and persons making) investment selections would be acting as investment advisers as defined in section 202(a)(11) of the Advisers Act, as would persons providing advice as to the selection or retention of an investment adviser or advisers.[34]

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32 The current form of the CSCA, however, does not clarify the relationship between the Trust and the Reserve Fund. Specifically, it is not clear whether the Reserve Fund would be part of the Trust, nor is it clear at what point in the employer remittance process any employee contribution would be considered part of the Trust.

33 The activities of persons that facilitate an investment program should be analyzed in determining whether a security has been created and the nature of any organized group that could be an investment company. *See, e.g., Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 756 F.2d 230 (1985) (finding that a program devised by broker-dealers to sell bank certificates of deposit entailed the issuance of a security separate from the certificate of deposit issued by the underlying bank). On multiple occasions, the SEC staff has addressed the status of security receipt programs as investment companies under the 1940 Act, considering the nature and structure of the program including the roles of integral persons. *See, e.g.,* HOLDRs, SEC No-Action Letter (pub. avail. Sept. 3, 1999).

34 *See, e.g.*, National Football League Players Association, SEC No-Action Letter (pub. avail. Jan. 25, 2002), citing Investment Advisers Act Release No. 1092 (Oct. 8, 1987), at note 6 and accompanying text (the selection of investment managers entails the provision of investment advice).

1940 Act Exceptions and Exemptions Would Not Apply. Section 3(c)(11) of the 1940 Act provides an exception from the definition of investment company for a collective trust fund maintained by a bank consisting solely of the assets of employee benefit plan trusts that are qualified under section 401 of the Internal Revenue Code ("IRC") and government plans. Plans qualified under section 401 entail imbedded protections for investors not present in IRAs and pooled IRAs that do not meet the requirements for qualification under section 401 of the IRC. The SEC staff has never extended the exclusion in section 3(c)(11) to bank collective funds that pool IRA assets or commingle the assets of IRAs with corporate plans qualified under section 401 of the IRC.[35] The CA Program does not meet the requirements of section 3(c)(11) of the 1940 Act because it will consist of IRA plan assets rather than 401(k) plan assets.

Rule 3a-4 under the 1940 Act provides a safe harbor from regulation as an investment company for investment advisory programs that meet certain conditions. It is not clear whether the managed accounts envisioned by the CA Program would entail sufficiently individualized advice and accountability to the participants to be eligible for reliance on rule 3a-4's safe harbor. Rule 3a-4's exemption is only available when a client has rights to withdraw securities and cash from the account, and can impose reasonable restrictions on the account, neither of which are contemplated by the CA Program. We note that it could be prohibitively expensive and burdensome for the CA Program to conform to rule 3a-4 under the 1940 Act.

The Regulatory Exclusion for State Entities. The role of the state of California in establishing the CA Program and requiring employers to facilitate automatic employee participation raises the question of whether the CA Program is exempt from regulation under the 1940 Act as a State Entity, as defined below. Since the 1940 Act was enacted, section 2(b) has exempted State Entities from regulation as investment companies.[36] Over time, the SEC staff has interpreted the exclusion based on the

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35 *See, e.g., Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, SEC (May 1992), at 133, citing Santa Barbara Bank and Trust, SEC No-Action Letter (pub. avail. Nov. 1, 1991); United Missouri Bank of Kansas City, N.A., SEC No-Action Letter (pub. avail. Dec. 31, 1981); Continental Illinois National Bank & Trust Co. of Chicago, SEC No-Action Letter (pub. avail. April 28,1975).

36 As originally passed, the 1940 Act included section 2(b) exactly as it exists today. 15 U.S.C. § 80a-2(b); Aug. 22, 1940, c. 686, Title I, § 2, 54 Stat. 790. The legislative history does not address the intended scope of the provision, aside from providing a clear indication that federal loan associations were presumed to be within the exclusion for government agencies. 76th Cong., 3d Sess. 103 (1940). It appears that section 3(a)(2) of the 1933 Act was the model for section 2(b) of the 1940 Act. Legislative history does not address the intended scope of section 3(a)(2). The legislative history of the Advisers Act is similarly silent.

development of various programs involving the collective investment of assets. Careful consideration must be given to whether and how that exclusion would apply to the CA Program because its novel structure and breadth present exactly the types of risks to participants that the 1940 Act was designed to address. Below we explain the exclusion from regulation and how it is currently interpreted by the SEC staff.

Section 2(b) of the 1940 Act specifically excepts from regulation any entity that is a state, a political subdivision of a state or any agency, authority, or instrumentality of any one or more of the foregoing (collectively, "State Entities"). Section 2(b) parallels exceptions in the federal securities laws under the 1933 Act and the Advisers Act.[37] The terms "agency," "authority" and "instrumentality" are not defined in the federal securities laws.

The exception in section 2(b) would be relevant to the "issuers" that are contemplated by the CA Program, such as the CA Program itself, the Trust and the Reserve Fund. On its face, the CSCA is silent as to whether the CA Program, the Trust or the Reserve Fund is a State Entity under the 1940 Act, or the federal securities laws generally. While proposed state legislation would provide that the Trust is an instrumentality of the state of California,[38] the proposal does not so address the CA Program itself, the Reserve Fund or the implications of the involvement of private sector employers.

SEC staff guidance applying section 2(b) to various State Entities provides a framework for considering the CA Program.

Prior Staff Approach to Section 2(b). As described below, the staff's framework for addressing various state initiatives under section 2(b) has evolved over time, but has always remained focused on the state's role and connection to the plans. As outlined below, the SEC staff has addressed a number of programs designed to allow governmental entities to invest assets belonging to the governmental entities (Cash Reserve Pools and Deferred Compensation Plans), as well as federally supported voluntary programs for college savings (Prepaid Tuition Plans). The staff has never addressed state-mandated retirement programs for private sector employees.

Cash Reserve Pools. In the late 1970s and early 1980s, the SEC staff addressed pooled vehicles that held only monies (for temporary cash reserve) that were the property of various governmental entities and no other persons. The staff provided

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37 *See* section 202(b) of the Advisers Act and section 3(a)(2) of the 1933 Act.

38 Cal. Gov. Code § 100004(f), as proposed to be added by California Senate Bill No. 1234 (2015-2016 Regular Session).

relief for those vehicles in a number of no-action letters under section 3(a)(2) of the 1933 Act and section 2(b) of the 1940 Act (the "Cash Reserve Letters").[39]

Deferred Compensation Plans. Throughout the mid-1970s, the SEC staff issued a series of no-action letters under section 2(b) of the 1940 Act and 3(a)(2) of the 1933 Act to various governmental agency deferred compensation plans.[40] Under those plans, government employers would by contract agree with their respective employees to defer a portion of the employees' compensation which would then be invested by the state ("Deferred Compensation Letters"). In those instances, the deferred compensation assets remained the property of the state, and the employees had a contractual claim against their state employer for the amounts they were owed.

Pooled Deferred Compensation Plans. Over time, the SEC staff also considered, and ultimately granted, no-action relief to arrangements of pooled deferred compensation plans of governmental agencies. After denying several initial requests, the SEC staff granted relief, specifically noting a number of important facts.[41] First, the monies invested would be from deferred compensation plans adopted by public employers pursuant to section 457 of the IRC ("457 Plans"), and all of the interests in the retirement trust would be owned by the public employers.[42] The employees themselves would not

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39 Massachusetts Municipal Depository Trust, SEC No-Action Letter (pub. avail. May 23, 1977); Pennsylvania Local Government Investment Trust, SEC No-Action Letter (pub. avail. Mar. 2, 1981); Pennsylvania School District Liquid Asset Trust SEC No-Action Letter (pub. avail. Mar. 26, 1982).

40 *E.g.,* State of Texas Deferred Compensation Plan, SEC No-Action Letter (pub. avail. Nov. 9, 1974); State of Oklahoma Public Employees'/Deferred Compensation Plan, SEC No-Action Letter (pub. avail. Mar. 19, 1976); School District No. 1 – Multnomah County, Oregon, SEC No-Action Letter (pub. avail. Apr. 26, 1976); Governmental Agency Deferred Compensation Plans, SEC No-Action Letter (pub. avail. Sept. 10, 1975); Home Savings & Loan Association, SEC No-Action Letter (pub. avail. Oct. 16, 1975); State of Delaware Deferred Compensation Plan, SEC No-Action Letter (pub. avail. Oct. 15, 1976).

41 Initially, the SEC staff had taken the position that an investment fund established by a state was a separate "issuer" from any State Entity under both the 1940 Act and the 1933 Act, and that it was not itself an agency, authority or instrumentality of a state or any political subdivision thereof. ICMA Retirement Corporation, SEC No-Action Letter (pub. avail. Mar. 4, 1974); ICMA Retirement Corporation, SEC No-Action Letter (pub. avail. Nov. 11, 1974).

42 Later, the staff granted further relief to allow the trust to accept funds from plans sponsored by public employers and qualified under IRC section 401. ICMA Retirement Trust, SEC No-Action Letter (pub. avail. Oct. 15, 1986).

have title to the assets in the trust, but rather would have a contractual claim against their respective public employers for the amount of the deferred assets owed to them.[43] Additionally, the SEC staff noted that any entity hired to provide investment advice to the trust would be registered with the SEC as an investment adviser, and trustees of the trust would approve the investment advisory contract no less frequently than annually.

In 1998, the Public Employees' Retirement Board of the State of Oregon requested relief under section 2(b) of the 1940 Act, section 3(a)(2) of the 1933 Act and section 3(a)(12) of the 1934 Act for a commingled trust of 457 Plan assets where the state of Oregon would be the legal owner of the trust.[44] Participants in the compensation plans would be beneficiaries of the trust but would not have legal title to the trust's assets. In granting the requested relief, the staff took the position that "[i]f, under state law, an issuer is a State Entity, the issuer is excluded from regulation as an investment company under section 2(b) of the [1940 Act], regardless of how it is structured or operated."[45] In its response, the staff closed out the line of letters pertaining to 457 Plans in the context of section 2(b).

It is relevant to note that in the incoming letter, it was acknowledged that the Oregon legislation did not specifically state that the fund in question was "an instrumentality of the State of Oregon," but noted several important facts relevant to the question of whether the fund was a State Entity. Specifically: (1) the fund was held by the state treasurer as custodian; and (2) the act establishing the fund provided that the state, the board and certain other persons would be immune from civil action for alleged breaches of their duties and indemnified from personal liability for violations of the federal or securities laws. Such immunity clauses, the incoming letter noted, are "common in the creation of public instrumentalities of state government."[46]

Prepaid Tuition Plans. Throughout the 1980s and 1990s, the SEC staff also issued a number of no-action letters regarding the application of section 2(b) of the 1940 Act and section 3(a)(2) of the 1933 Act in the context of prepaid college tuition programs that

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43 ICMA Retirement Trust, SEC No-Action Letter (pub. avail. Feb. 7, 1983).

44 The impetus for this subsequent request for relief arose when section 457 of the IRC was amended to require that all assets and income "be held in trust for the exclusive benefit of participants and their beneficiaries." *See* Public Employees' Retirement Board of the State of Oregon, SEC No-Action Letter (pub. avail. Mar. 3, 1998), citing sections 1448(a) and (b) of the Small Business Job Protection Act of 1996, P.L. 104-18 (1996).

45 Public Employees' Retirement Board of the State of Oregon, SEC No-Action Letter (pub. avail. Mar. 3, 1998), at 2.

46 *Id*. (incoming letter at 3).

comport with section 529 of the IRC ("529 Plans").[47] These letters were an important component of the development of the framework for the staff's State Entity analysis.[48]

To address the lack of express wording under state law, the staff originally established a set of factors to assess state law and the intent of state legislatures (the "Factors"). They were: (i) whether the entity administering the program was specifically created by a state statute that identifies the state interest in encouraging a particular public policy; (ii) whether the members of the entity's Board of Directors were appointed by the governor or some other elected state official; and (iii) whether the entity was required to submit annual reports to its board for review.[49] In one letter, the staff also noted that the obligations of the program were guaranteed by the full faith and credit of the state.[50]

As with 457 Plans, the SEC staff confirmed the application of section 2(b) to 529 Plans.[51] In the context of 529 Plans, the enactment of section 529 of the IRC reflected an

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47 *See, e.g.,* Colorado Prepaid Tuition Fund by the Colorado Student Obligation Bond Authority et al., *infra* note 49.

48 The staff has also granted similar relief to 529 Plans operating as asset allocation college savings programs rather than prepaid tuition plans. Notably, in these types of programs, the investor is making a voluntary decision to invest, and when the 529 Plan is a college savings program through which participants' assets are allocated to underlying investment options, those investment options are typically registered funds. *See, e.g.*, Parental Savings Trust Fund, SEC No-Action Letter (pub. avail. March 24, 1997)(granting relief with respect to section 2(b) of the 1940 Act, section 3(a)(2) of the 1933 Act, section 304(a)(4)(A) of the Trust Indenture Act of 1939 and sections 15(b) and 15B(a) of the 1934 Act).

49 Colorado Prepaid Tuition Fund by the Colorado Student Obligation Bond Authority, SEC No-Action Letter (pub. avail. Sept. 12, 1997), citing Parental Savings Trust Fund SEC No-Action Letter (pub. avail. Mar. 24, 1997); Virginia Higher Education Tuition Trust Fund SEC No-Action Letter (pub. avail. Nov. 5, 1996); Florida Prepaid College Tuition Program SEC No-Action Letter (pub. avail. Sept. 12, 1990); State of Ohio; Ohio Tuition Trust Authority, SEC No-Action Letter (pub. avail. Aug. 6, 1990); Michigan Education Trust, SEC No-Action Letter (pub. avail. June 30, 1988).

50 Colorado Prepaid Tuition Fund by the Colorado Student Obligation Bond Authority, *supra* note 49, referring to Florida Prepaid College Tuition Program, *supra* note 49.

51 *See* State of Ohio; Ohio Tuition Trust Authority, SEC No-Action Letter (pub. avail. Aug. 6, 1990). At least one of the incoming letters regarding tuition payment programs explained that two of the purposes of the program (among others) were to

acknowledgement by Congress of the need for federal tax protection for tuition savings plans. At the end of this line of letters, the SEC staff took the position that the "ultimate issue" in analyzing these programs under section 2(b) of the 1940 Act was whether, under state law, the entity whose status is in question is a State Entity.[52] The staff noted, however, that the Factors are relevant to the extent that they help to resolve that ultimate issue.[53] Often, such guidance is necessary because state law does not always specify whether the program in question is a State Entity under state law.

CA Program Would Significantly Expand Prior Relief. As explained above, the SEC staff has not previously addressed state-mandated retirement programs for private sector employees. In fact, the CA Program differs in significant respects from the programs and plans for which the SEC staff has provided no-action relief in the past. Providing relief to the CA Program therefore would not only be a significant departure from prior staff positions, but would raise the question of whether the many state retirement plans for private sector employees across the country should receive similar relief.[54]

The CA Program differs from plans and programs under prior staff no-action letters issued under section 2(b) in the following important respects:

- The CA Program involves a significantly greater degree of private sector involvement than other programs considered by the SEC staff, and would substantially extend the boundaries of section 2(b). The CA Program uses private sector employers to increase retirement savings by private sector employees. By contrast, the letters the SEC staff has issued under section 2(b) generally involve a state facilitating a state interest (retirement savings for state employees in the context of 457 Plans or providing residents of the state with greater access to higher education in the context of 529 Plans), directly serving a state function (facilitation of cash investment of municipalities) or facilitating a Congressionally articulated federal interest (*e.g.*, 529 Plans).

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help make education affordable and accessible to all citizens of the state, and to maintain state institutions of higher education (as defined in the act) by helping to provide a stable financial base to those institutions.

52 In its response, the staff closed out the line of letters pertaining to prepaid tuition programs in the context of section 2(b). Colorado Prepaid Tuition Fund by the Colorado Student Obligation Bond Authority, *supra* note 49.

53 Colorado Prepaid Tuition Fund by the Colorado Student Obligation Bond Authority, *supra* note 49.

54 *See supra* note 1.

- The investors in the CA Program are potentially more vulnerable than those considered by the staff in prior letters under section 2(b). Many employee participants in the CA Program will be of limited income, and would be automatically enrolled unless they took affirmative steps to opt out initially and then remained vigilant in repeatedly opting out thereafter.[55] As a practical matter, the CA Program will be effectively mandatory for many participants.[56] By contrast, in prior letters the SEC staff has issued involving 529 Plans, participants would initiate their own contributions.

- Due to the lack of apparent safeguards, the CA Program raises greater risks to investors than the plans and programs considered by the SEC staff in prior letters under section 2(b). First, the private sector employers in the CA Program will have access to participant monies (for instance, in the remittance process) and will not be State Entities or licensed intermediaries. As discussed further below, it appears that there are no controls contemplated to ensure safeguarding of employees' contributions at the employer level. By contrast, many of the letters submitted to the staff in the 457 Plan and 529 Plan contexts recited one or more investor protection elements to allow the staff to be comfortable that relief should be granted. Examples of such safeguards are: (i) having money custodied by a third party custodian, who would be required to send reports back to the state and local government confirming how monies were allocated among the investment options and investment vehicles;[57] (ii) requiring any entity that was hired to provide investment advice to the trust to be registered with the SEC as an investment adviser;[58] or (iii) having trustees of the trust approve the trust's investment advisory contract no less frequently than annually.[59]

The CA Program Directly Implicates the Investor Protection Concerns Underlying the 1940 Act. Section 1 of the 1940 Act states that investment companies

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55 As discussed in the Background section of this Memorandum, the 6.8 million California employees that are expected to be eligible to participate in the program have a *median* wage and salary income of $23,000.

56 The Overture Report estimated that participation would be significantly increased if the CA Program was structured as an opt out program rather than following an opt in or active choice approach, and specifically acknowledged that the opt out structure would cause the "greatest difference for low-wage workers."

57 Public Employees' Retirement Board of the State of Oregon, SEC No-Action Letter (pub. avail. Mar. 3, 1998).

58 ICMA Retirement Trust, SEC No-Action Letter (pub. avail. Feb. 7, 1983).

59 *Id.*

are affected with a national public interest, and it lists in detail the particular public policy concerns at issue in connection with the operation of unregistered investment companies. Section 1 also provides that the 1940 Act shall be interpreted to mitigate and eliminate the enumerated public policy concerns raised by investment companies. The CA Program directly implicates many of the concerns. If the program is not subject to the protections of the 1940 Act, the private sector employees that participate in the program would be left with very limited federal protections for their retirement savings under the program. Indeed, if the current DOL proposal is adopted in its present form, state sponsors of payroll deduction savings programs, including the CA Program, will likely be outside the scope of ERISA and not subject to many of its protections.[60]

The manner in which the CA Program implicates some of the key concerns underlying the 1940 Act is briefly summarized below.

Potential for Misappropriation or Loss of Assets. The CSCA contains limited self-dealing prohibitions that are not as robust as those in the 1940 Act.[61] The threat of the loss or misappropriation of assets due to lack of custody protections is not addressed by the CSCA. For example, the CSCA does not impose safeguards on the remittance by private sector employers of employee contributions to the CA Program to ensure that an employer will remit the contributions as required, properly account for an increase or decrease in salary, or pass along a final remittance after termination of employment. Instead, the program appears to place the burden on the employee participants to self-advocate and ensure proper funding of their accounts. In addition, in certain circumstances, participant assets could become the property of the state of California. As noted by K&L Gates regarding the CA Program, "[I]f the [R]eserve [F]und becomes sizable, the [CA] Board and the state government may face pressure to 'break open' the reserve for immediate allocation or, conceivably, some state purpose outside the [CA Program]."

Recordkeeping. The collective investment of participant assets as contemplated by the CA Program will require highly complex recordkeeping both of individual

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60 *See* Savings Arrangements Established by States for Non-Governmental Employees, *supra* note 13.

61 Cal. Gov. Code § 100002(c) and (d), and § 100004(e) (Jan. 1, 2013), as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session). More specifically, for example, the CSCA prohibits certain transactions involving "a [CA Board] member, program administrator, and other staff of the [CA Board]," but those prohibitions would not apply to other service providers or their affiliates (*e.g.*, asset managers hired to manage Trust assets). Cal. Gov. Code § 100002(c) (Jan. 1, 2013), as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session).

participant and pooled assets, and is fraught with the opportunity for meaningful error. Improper recordkeeping could wipe out participant savings. For instance, the CSCA includes no specific recordkeeping requirements relating to employers' deduction and remittance of employee payroll amounts to be invested in the CA Program. Similarly, it is unclear how recordkeeping would be handled for a participant in the CA Program who moves from one job to another and then perhaps into a different state. Failure to effectively address these important recordkeeping issues presents a material risk of loss to employee participants in the CA Program.

Disclosure to Participants. The CA Program will not be subject to the rigorous disclosure regime of the federal securities laws, which would include protections ranging from the delivery of audited financial statements and prospectuses to participants, to the provision of information about who will provide investment advice with respect to assets in the CA Program. While the CSCA provides for certain disclosures to participants, there is no mechanism that provides accountability for the adequacy or accuracy of disclosures to participants about their investments.[62] Participants may not have sufficient information about the CA Program to make an informed decision about whether to opt out of the program. For instance, it is not clear how material changes to the CA Program, such as increases in contribution amounts or changes in fees, will be disclosed to participants in a timely manner.

Inequitable Terms of Securities. The structure and functioning of the CA Program and certain aspects thereof (particularly he Reserve Fund) could entail inequitable provisions in the terms of the securities held by participants. As noted by K&L Gates regarding the CA Program, "[S]ome early participants and short term participants may not benefit from the reserve and could even experience reduced returns in good market years when 'excess returns' are funneled to the reserve fund. Others, who participate in bad years, may benefit from the reserve accumulated by previous investors."

General. Congress effected the policy goals enumerated in Section 1 through its enactment of the specific provisions of the 1940 Act that govern the operations and activities of investment companies. The employees who participate in the CA Program need the protections that are supplied under the 1940 Act, relating to, among other things, investment advisory arrangements and their associated fees (Section 15), valuation of portfolio securities (Section 2(a)(41)), provisions to address conflicts of interest and custody arrangements (Section 17) and disclosure (Section 8). Without these protections, the interests offered by the CA Program would leave the employees vulnerable to inaccurate, incomplete or even misleading disclosures and potential asset loss due to lack of effective controls or even potential overreaching by those who operate the CA Program and otherwise invest the employees' contributions.

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[62] Cal. Gov. Code § 100014 (Jan. 1, 2013), as proposed to be amended by California Senate Bill No. 1234 (2015-2016 Regular Session).

Furthermore, the CA Program also lacks the elements of independent oversight that would help to protect the private sector employees from those risks, including such elements as the presence of independent directors and a compliance officer.

CONCLUSION

The CA Program presents significant investor protection concerns of the type the 1940 Act was designed to address. The CA Program will cause low income, private sector employees to collectively invest for retirement without the protections of the federal securities laws. As outlined above, the CA Program entails the creation of one or more unregistered investment companies that will present risks to the public without the protections of the 1940 Act.

The SEC and its staff should be very cautious about providing any regulatory relief or confirming the availability of any exemption or exclusion from regulation because those actions would entail a meaningful departure from prior staff relief, leaving participants exposed to material risks. The SEC and the staff should focus closely on the essentially unregulated role to be played by private sector employers in facilitating the CA Program. And finally, the current lack of factual clarity surrounding the CA Program also casts doubts on the appropriateness of providing any relief.

INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

March 24, 2016

Delivered Electronically

The Honorable John Chiang
California State Treasurer
Chairman, California Secure Choice Retirement Savings Investment Board
915 Capitol Mall, Room 110
Sacramento, CA 95814

Re: Overture Financial Final Report to the California Secure Choice Retirement Savings Investment Board

Dear Treasurer Chiang:

The Investment Company Institute[1] appreciates the opportunity to provide comments on the Report (the "Report") prepared by Overture Financial LLC to the California Secure Choice Retirement Savings Investment Board (the "Board").[2] The Report reflects the market analysis, financial feasibility study, and program design recommendations of Overture Financial and its subcontractors with respect to the California Secure Choice Retirement Savings Program (the "Program"). The Program is contemplated as a state-run retirement savings plan for private-sector workers in California, pursuant to the California Secure Choice Retirement Savings Trust Act (SB 1234), enacted in 2012.

The Institute strongly supports efforts to promote retirement security for American workers. We understand and appreciate the interest shown by the state of California in ensuring that its residents have sufficient resources for retirement and share the goal of increasing workplace retirement plan access. Our member companies devote considerable effort to helping Americans prepare for and achieve a financially secure retirement. Due in part to the innovation that has taken place over the last few decades in the private sector, Americans currently have $24.0 trillion saved for retirement, with more than half of that amount in defined contribution ("DC") plans and individual retirement

[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $16.9 trillion and serve more than 90 million U.S. shareholders.

[2] The Report is dated March 17, 2016 and is available at www.treasurer.ca.gov/scib/report.pdf.

accounts ("IRAs").[3] About half of DC plan and IRA assets are invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers. The Institute has 36 member companies located in California with about 16,000 employees in the state and $3.5 trillion in assets under management. These California-based companies, as well as mutual fund companies based outside of California, provide investments and other services to retirement plans and individual retirement savers in California. Our members are eager to serve this marketplace with increasingly competitive product and service offerings.

We appreciate that the Board faces a significant challenge in making an informed, sound assessment of the Program. Unfortunately, the Report does not provide adequate support to meet that challenge. While the Report contains a great deal of survey data on the characteristics and views of workers without employer-provided retirement plan coverage, it fails to provide an adequate analysis of the financial feasibility of the Program. We are concerned that Program participants or California taxpayers—or most likely both—will find themselves bearing unanticipated costs as a result of the Program.

We urge the Board to conduct further analysis before moving forward with the Program. Many of the assumptions and conclusions in the Report, which are used to justify the Program's design, appear unrealistic or incomplete. This is the case even under the "pessimistic scenario" analyzed in the Report. Without additional information about the financial feasibility of the Program, we question how the Board can truly assess the Program, much less recommend it for further action by the California State Legislature.

The Program also raises important legal questions, as described in our November 15, 2013 letter to Mr. Grant Boyken responding to the California Secure Choice Retirement Savings Program Request for Information.[4] These legal questions—including the application of the Employee Retirement Income Security Act of 1974 ("ERISA") and federal securities laws—have yet to be sufficiently answered. In particular, SB 1234 requires that prior to implementation, the Board must find that the Program accounts will qualify for the favorable federal income tax treatment accorded to IRAs under the Internal Revenue Code, and that the Program is not an employee benefit plan under ERISA. As you know, the ERISA status of state-based programs is the subject of a pending rulemaking project at the U.S. Department of Labor ("DOL").[5] As the Report acknowledges, it is unclear whether

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[3] *See* Table 1 in Investment Company Institute, "The U.S. Retirement Market, Fourth Quarter 2015" (Mar. 2016); available at www.ici.org/info/ret_15_q4_data.xls.

[4] The letter is available at www.treasurer.ca.gov/scib/rfi/ici.pdf.

[5] DOL has proposed a regulatory safe harbor from coverage under ERISA for certain payroll-deduction IRA arrangements established and maintained by state governments. Savings Arrangements Established by States for Non-Governmental Employees, 80 Fed. Reg. 72006 (November 18, 2015). Under the safe harbor, these state arrangements would not be treated as employee benefit plans under ERISA, as long as specified conditions are met, including that state law requires certain employers to make the program available to employees. We do not believe that this proposal settles the ERISA status of any

certain investment structures would be permissible in a state-run retirement savings program and we understand that the Board may be seeking guidance from the Securities and Exchange Commission on those matters. These matters must be resolved before the Board considers recommending the Program.

More broadly, we are concerned that initiatives like that under consideration in California will ultimately lead to the creation of a fragmented, state-by-state system of retirement savings for private-sector workers.[6] A patchwork of state-run programs, each with its own unique rules, has the potential to harm the voluntary system for retirement savings that is helping millions of American private-sector workers achieve retirement security. In our view, the research and data suggest that these state initiatives are misplaced and that there are other more targeted changes at the national level that will be more effective at increasing access to payroll-deduction savings opportunities.[7]

We discuss our views of the Report below. First, we explain our concerns about the adequacy of the financial feasibility study in the Report, noting that the Report fails to adequately consider probable inaccuracies in the Report's assumptions that call into question the financial feasibility of the Program. The most significant of these are the Report's assumptions about opt-out rates, contribution rates, and withdrawal and turnover activity, which are all critical factors in the Report's conclusions. We also highlight the Report's failure to adequately account for all likely costs in implementing and operating the Program.

Second, we describe our broader concern about a fundamental assumption on which the perceived need for mandatory state-run retirement plans is based—that workers currently not covered

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particular state-run program, as it has not been finalized and, even if finalized in its current form, application of the safe harbor to any particular program would be a facts and circumstances determination that ultimately would rest in the hands of a court of law. As DOL noted, "the objective of the proposed safe harbor is to diminish the chances that, if the issue were ultimately litigated, the courts would conclude that state payroll deduction savings arrangements are preempted by ERISA." 80 Fed. Reg. 72009. DOL also notes that "courts' determinations would depend on the precise details of the statute at issue, *including whether that state's program successfully met the requirements of the safe harbor*." 80 Fed. Reg. 72011 (emphasis added).

[6] *See* letter from Investment Company Institute to U.S. Department of Labor, dated January 19, 2016; available at www.dol.gov/ebsa/pdf/1210-AB71-00062.pdf. Section 514 of the Employee Retirement Income Security Act of 1974 ("ERISA") provides that ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan" covered by the statute. The intent of ERISA preemption is to avoid subjecting employers to a patchwork of different and likely conflicting requirements under potentially 50 state laws. With state laws such as SB 1234, employers that operate in multiple states or employ workers residing in more than one state will face significant burdens complying with differing requirements regarding covered employees, the type of retirement plan that will exempt an employer from the state's program, contribution rates, and automatic enrollment features, among others.

[7] For a description of such targeted changes, *see* letter from Investment Company Institute to U.S. Department of Labor, dated January 19, 2016; available at www.dol.gov/ebsa/pdf/1210-AB71-00062.pdf.

by employer-sponsored retirement plans will be best served by being automatically enrolled in such programs.

I. The Report Fails to Adequately Consider Probable Scenarios That Call into Question the Financial Feasibility of the Program

The Report concludes that "[t]he Secure Choice Program is financially viable and self-sustaining even under adverse conditions with poor investment returns and high "opt-outs" rates."[8] The Report rests this conclusion on a long list of assumptions, many of which are not likely to hold true. As a result, we fear that the Program is not nearly as financially secure and self-sustaining as it is portrayed to be. We recognize that attempting to model costs of any proposed initiative is a difficult and uncertain exercise, but we strongly caution that the Report does not appear to have fully considered many scenarios that are entirely possible, if not probable. Any combination of these alternative scenarios could result in much lower assets and much higher costs than suggested by the baseline scenario or the one-off changes studied. In addition, there appear to be costs that are not considered in the analysis even under the "pessimistic scenario" which specify a 10-year payoff period and $186 million funding gap.[9]

In this respect, there are several risks that could significantly affect the Program's asset growth and cost estimates. The most significant of these risks include the Report's assumptions about opt-out rates, contribution rates, and withdrawal activity and turnover, and the Report's failure to adequately account for all likely costs. We discuss each of these risks in more detail below. The Report also appears to rely on averages, which as a methodology does not recognize the range of workers and range of account balances and participation rates that may occur. This variability can have a material impact on the assets and costs of the Program.

A. The opt-out rate is a key risk to the Program's ability to build assets and manage costs

It is important for the Board to be aware that it is quite likely that automatic enrollment in the Program may not have results close to those produced by automatic enrollment in voluntary private-sector retirement plans. In this respect, the opt-out rate for the Program may be higher on average than is projected in the Report, or could be distributed across employers in a way that is more costly than projected. Plan design and workforce demographics affect opt-out rates and both are quite different between the private-sector retirement plans voluntarily implementing automatic enrollment and the proposed state-mandated Program to be applied to employers without plans.

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[8] *See* page 110 in the Report.

[9] *See* page 119 in the Report.

1. Plan design affects opt-out rates

The Report's baseline opt-out rate assumption for the Program likely is overly optimistic. Automatic enrollment may not be anywhere nearly as successful in increasing participation in California's Program as it is among employers who voluntarily adopt it for the plans that they offer their employees. First, automatic enrollment has been adopted more widely in the private sector by larger employers.[10] Such employers often combine automatic enrollment with other participation incentives such as employer contributions (which provide an immediate and positive incentive to save) and the availability of participant loans (which provides flexible access to the savings).[11]

The Board would be ill-advised to assume that participation and opt-out experience in the Program will be close to the private-sector experience, because it is difficult to disentangle the impact of one plan feature in isolation and some of the results achieved with automatic enrollment may also reflect the influence of other plan features. For example, BrightScope and ICI analyzed a sample of nearly 54,000 401(k) plans with 100 participants or more and at least $1 million in plan assets and found that 401(k) plans tend to have combinations of plan features.[12] The most common combination of plan features offered to workers includes employer contributions, which provides immediate growth in the 401(k) balance, and participant loans, which provides flexibility that in turn promotes larger contributions.[13] While the Program presumably would offer access to the accounts through withdrawals, which provides some flexibility, it would not provide employer or state contributions.[14]

[10] *See* Utkus and Young, *How America Saves, 2015: A report on Vanguard 2014 defined contribution plan data*, Valley Forge, PA: The Vanguard Group (2015); available at https://institutional.vanguard.com/iam/pdf/HAS15.pdf.

[11] In the case of state-sponsored retirement plans that are IRAs, individuals could access the accounts through withdrawals. However, amounts withdrawn may be subject to penalties and/or income tax.

[12] Private-sector 401(k) plans with automatic enrollment are more likely to have both employer contributions and participant loans outstanding than plans without automatic enrollment. In 2013, 74 percent of 401(k) plans with automatic enrollment had employer contributions and outstanding participant loans. Nearly nine in 10 401(k) plans with automatic enrollment had employer contributions. *See* BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2013*, San Diego, CA: BrightScope and Washington, DC: Investment Company Institute (December 2015); available at www.ici.org/pdf/ppr_15_dcplan_profile_401k.pdf.

[13] *Id. See also* Beshears, Choi, Laibson, and Madrian, "The Impact of 401(k) Loans on Saving," *NBER Retirement Research Center Paper*, no. NB 09-05, Cambridge, MA: National Bureau of Economic Research (September 2010); available at www.nber.org/aging/rrc/papers/orrc09-05.pdf.

[14] *Id.* In addition, Beshears et al. (2007) studied savings plan participation at nine firms with automatic enrollment and variation in their match structures. Although they caution that the potential existence of firm-level omitted variables means the results should be interpreted with caution, they conclude that the analysis suggests that "moving from a typical matching structure—a match of 50 [percent] up to 6 [percent] of pay contributed—to no match would reduce participation under automatic enrollment at six months after plan eligibility by 5 to 11 percentage points." *See* Beshears, Choi, Laibson, and Madrian, "The Impact of Employer Matching on Savings Plan Participation under Automatic Enrollment," *NBER*

Second, sponsors and administrators of private-sector plans provide extensive participant education on the importance of saving and investing, through materials and website tools, which plays a key supporting role in increasing participation (Figure 1). The depth and breadth of these educational efforts help inform employees of the benefits of the 401(k) plan and the importance of saving for retirement. All of these features contribute to the success of automatic enrollment in the voluntary private retirement system, but it is far from clear that they will be present in the context of state-mandated payroll-deduction IRAs.

Academic research has examined the effectiveness of automatic enrollment in the context of private-sector 401(k) plans that added the feature to already existing plans.[15] These plans typically have extensive educational programs in place, including materials to promote the importance of saving for retirement, explanations of investment types and the trade-off between risk and return, and the features of their plans.[16] Household survey results highlight that about nine in 10 households with DC plan accounts agreed that their employer-sponsored retirement plan helped them to think about the long-term, not just their current needs.[17]

Third, private-sector 401(k) plans offer an array of investment options, typically covering a range of investment risks and returns (Figure 1). Household surveys find that DC-owning households generally appreciate the investment choice and control and agree that their DC plan offers a good line-up of investment options.[18] All of these factors suggest that the Program will find it difficult to replicate the success of the private sector.

A final factor that may depress participation rates for the Program compared with private-sector 401(k) participation rates is the complexity around IRA contribution rules. It is not clear how the educational materials and enrollment process will help workers make sure that their contributions to the Program are within the legal requirements surrounding IRAs, which may result in some workers

Retirement Research Center Paper, no. NB 07-09, Cambridge, MA: National Bureau of Economic Research (August 2007); available at www.nber.org/aging/rrc/papers/orrc07-09.pdf.

[15] For example, *see* Madrian and Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics* 116, no. 4 (2001): 1149-1187; available at http://qje.oxfordjournals.org/content/116/4/1149.abstract.

[16] *See* Plan Sponsor Council of America, *58th Annual Survey of Profit Sharing and 401(k) Plans: Reflecting 2014 Plan Experience*, Chicago: Plan Sponsor Council of America (2015), which reports on the educational materials and activities used in 401(k) plans and the goals of the educational programs. *See also*, Figure 1 in this letter.

[17] *See* Figure 2 in Holden, Burham, Bogdan, and Schrass, "American Views on Defined Contribution Plan Saving, 2015," *ICI Research Report,* Washington, DC: Investment Company Institute (February 2016); available at www.ici.org/pdf/ppr_16_dc_plan_saving.pdf. Results are based on a survey of more than 3,000 U.S. adults from mid-November 2015 to mid-December 2015, of which more than half owned DC plan accounts.

[18] *Id.*

opting out due to confusion,[19] and others having difficulties when they ultimately file their taxes. The instructions for determining IRA contribution eligibility may themselves have the effect of putting off workers.[20]

[19] The historical data indicate that when traditional IRA contributions were universally allowed from 1982 to 1986, many low-income workers joined the ranks of traditional IRA contributors. When income limits and restrictions based on employer-sponsored retirement plan coverage were placed on traditional IRA contribution eligibility, the data indicate that many lower-income taxpayers stopped contributing, even if they were eligible to make tax-deferred contributions—suggesting confusion around the rules governing contributions. *See* discussion in Holden, Ireland, Leonard-Chambers. and Bogdan., "The Individual Retirement Account at Age 30: A Retrospective," *Investment Company Institute Perspective* 11, no. 1 (February 2005); available at www.ici.org/pdf/per11-01.pdf.

[20] For the instructions on determining IRA contribution eligibility, *see* U.S. Department of Treasury, Internal Revenue Service, "Contributions to Individual Retirement Arrangements (IRAs), For use in preparing 2015 Returns," *Publication 590-A*; available at www.irs.gov/pub/irs-pdf/p590a.pdf.

Figure 1
Private-Sector Retirement Plans Provide a Great Deal of Support

	Private-sector 401(k) plans	Proposed state program
Employer contributions	76% of 401(k) plans covering 88% of 401(k) participants have employer contributions[1]	None
Participant education	68% of 401(k) plans email plan communications[2] 57% websites for the plan 45% individually targeted communications 53% seminars or workshops 40% newsletters 36% retirement gap calculators 29% retirement income projections 17% mobile apps	Plan materials for distribution by employer
Employee contributions	58% of 401(k) plans allow Roth 401(k) contributions[2] All 401(k) plans allow pre-tax contributions	Roth IRA; unless not eligible Deductible traditional IRA; unless not eligible After-tax traditional IRA
Account access	87% of 401(k) participants are in plans that offer loans[3] Hardship withdrawals In-service withdrawals (age 59½ or older)	Hardship withdrawals Penalty-free withdrawals (age 59½ or older)
Investments	Average 27 investment options[4] Default, typically a target date fund[5]	Unclear number of options Default, under review

[1] BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2013* (December 2015).
[2] Plan Sponsor Council of America, *58th Annual Survey of Profit Sharing and 401(k) Plans: Reflecting 2014 Plan Experience*, Chicago, IL: Plan Sponsor Council of America (2015). Plans provide multiple types of educational materials. Figures reported are percentage of 401(k) plans using the educational material indicated.
[3] Holden et al., "401(k) Plan Asset Allocation, Account Balances, and Loan Activity, 2013," *ICI Research Perspective* and *EBRI Issue Brief* (December 2014).
[4] BrightScope and Investment Company Institute, *The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2013* (December 2015).
Sources: See notes above.

2. Workforce demographics also affect opt-out rates

Workforces of employers without retirement plans differ from those with retirement plans.[21] As the Program is intended to serve workforces at employers that have not voluntarily adopted retirement plans, workforce demographics may adversely affect participation and opt-out rates for the Program relative to those for voluntary private-sector plans.

As is the case nationwide, workforces at California employers without retirement plans tend to be younger, lower-income, and not working full-time, or full-year (Figure 2).[22] In this respect, younger workers tend to be focused on other savings goals and paying down debt, and lower-income workers tend to be focused on saving for emergencies and meeting current needs. Lower income workers are also more likely to receive high replacement rates from Social Security.[23] In California, 35 percent of workers at employers without retirement plans are younger than 30, compared with 22 percent of workers at employers with plans. Fifty-eight percent of workers at employers without retirement plans earn less than $27,000, compared with only 24 percent of workers at employers with plans. Only 57 percent of workers at employers without retirement plans work full-time, full-year, compared with 77 percent of workers at employers with plans.

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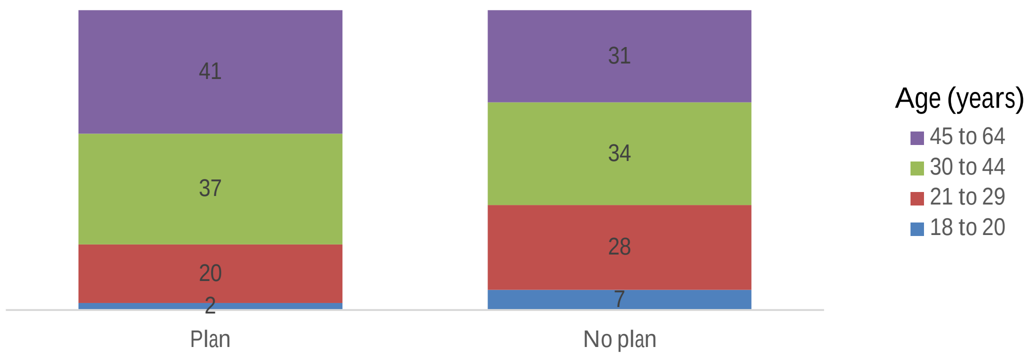
[21] Differences in workforce composition appear to be a primary cause for the lower rate at which small employers sponsor retirement plans. *See* nationwide analysis in Figure 4 and discussion in Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf.

[22] ICI used the description of the CPS sample analyzed in the Report to do additional analysis of the pool of eligible California workers (*see* page 26 in the Report). Although, we caution that the latest CPS resulted in a change to the survey that understates retirement plan coverage (*see* note 42). Additionally, there is the difficulty that the weights in the CPS are for national calculations not regional or state-specific. We were able to closely replicate the wage and salary distribution of the eligible California workers, but found different results for employment status. Figure C-6 on page 31 of the Report indicates that 83 percent of eligible California workers are full-time, while our analysis of the CPS data finds that 73 percent are full-time, with the key difference in the percentage that are full-time, full-year, which is 66 percent in the Report, and 57 percent in our analysis of the data (Figure 2 in this letter). It appears that the feasibility study assumes 75 percent of eligible workers are full-time and 25 percent are part-time (*see* page 112 of the Report), even though we believe that it makes more sense to group full-time and not full-year workers with the other workers also less connected to the workforce.

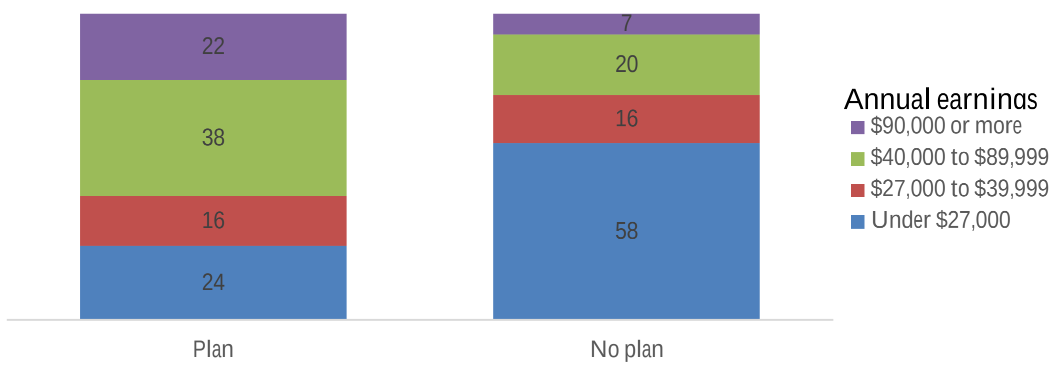
[23] The Congressional Budget Office reports estimated replacement rates from scheduled Social Security payments, and Social Security replaces a higher percentage of pre-retirement earnings for workers in lower-income households than it does for workers in higher-income households. *See* Congressional Budget Office, *CBO's 2015 Long-Term Projections for Social Security: Additional Information* (December 2015); available at www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51047-SSUpdate.pdf.

Figure 2
Workforces at Employers with Retirement Plans Differ from Those Without Plans
Percentage of private-sector wage and salary workers age 18 to 64 in California, 2012–2014

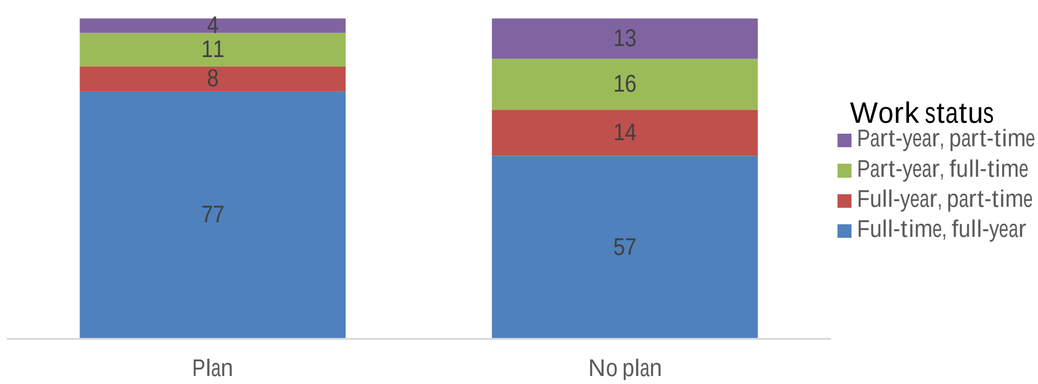
Workforces at employers without retirement plans tend to be younger



Workforces at employers without retirement plans tend to be lower-income



Workers at employers without retirement plans tend to be less connected to the employer



Note: Sample is California private-sector wage and salary workers, age 18 to 64. The data are from CPS conducted in the years 2013–2015, reflecting retirement plan coverage in the prior year (2012–2014).
Source: ICI tabulation of Current Population Survey data

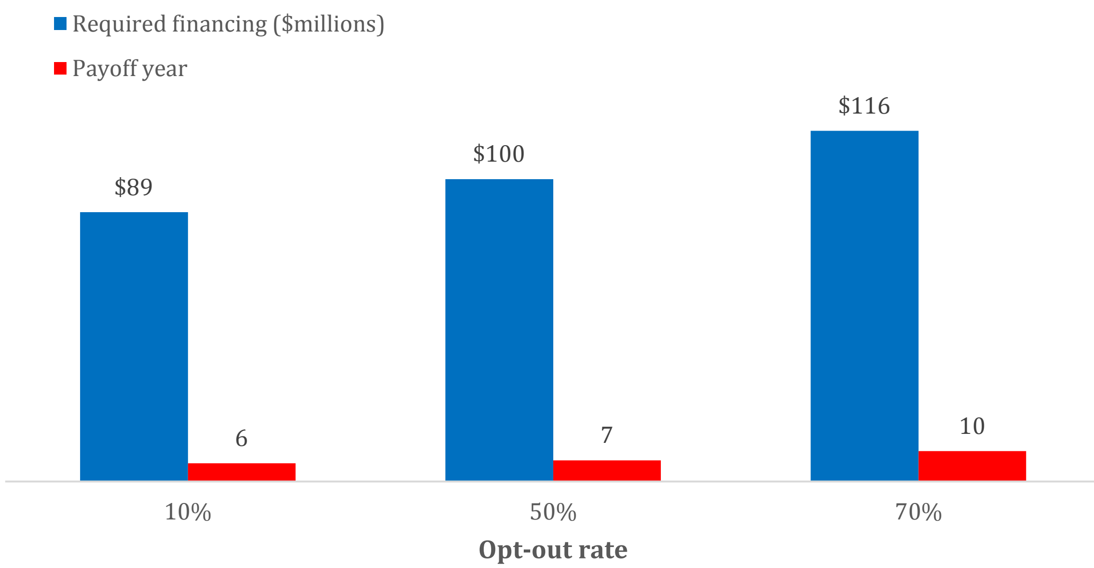
Opt-out rates may impose significant costs on workers, as well. Participants who opt out after accounts have been created may face tax penalties or incur additional consumer debt, perhaps suffering avoidable financial stress. The DOL has expressed concern that certain workers who fail to opt out of state programs may be very economically vulnerable.[24] As explained above, workers at employers without retirement plans often are lower-income (58 percent of California workers without retirement plans at their current jobs have annual earnings of less than $27,000; Figure 2). While analysis of this potential outcome is beyond the scope of the financial feasibility study for the Program, the Board should be mindful of these risks.

3. Opt-out rates will affect the financial feasibility of the Program

As discussed above, research regarding the impact of automatic enrollment cannot predict the Program's opt-out rates, which may prove significantly higher than those predicted by the experience of private-sector automatic enrollment in 401(k) plans. The Report shows that higher opt-out rates will impact the funding and breakeven period for the Program. Its analysis indicates that the breakeven period will increase from 6 to 10 years and the financing needs will increase by 30 percent (from $89 million to $116 million) if the opt-out rate rises from 10 percent to 70 percent (Figure 3). Given sunk costs, fixed-costs, and per-employer costs, it is perplexing that the Report finds that the opt-out rate must rise to 70 percent before that rate has dramatically different effects on Program financing. Although the Report identifies this risk, it does not consider high opt-out rates even in its "pessimistic scenario."

[24] For research supporting this concern, *see* Beshears, Choi, Laibson, and Madrian, "Default Stickiness among Low-Income Individuals," *Social Security Administration Retirement Research Consortium Paper* (October 11, 2012); available at http://gsm.ucdavis.edu/sites/main/files/file-attachments/lowincomedefaults.pdf.

Figure 3
Impact of Opt-Out Rates on Financing Needs to Consider More Scenarios
Opt-out rate changes financing and payoff year little except in the extreme scenario



Note: *See* page 118 of the Report.
Source: Overture Financial Final Report

The Board should analyze more opt-out scenarios and ensure that the underlying calculations fully take into account the impact of sunk costs, fixed costs, and per-employer costs. Figure 4 presents simple numerical examples that highlight the impact of higher opt-out rates on the Program's variable recordkeeping costs. In the first panel, the variable recordkeeping costs from the direct servicing model are calculated for the scenario where there are 100,000 employers offering the Program to their workers. On average, 10 employees per employer participate in the Program, resulting in 1 million participants with IRA balances. The average variable cost of recordkeeping is $35 per participant in this scenario (Example 1). But, what if the opt-out rate is higher and fewer employees decide to open an IRA under the Program? If on average, there were only one participant per employer, the average variable cost of recordkeeping climbs to $170 per participant (Example 2).[25] This is not to suggest that only one worker per employer will participate, but to highlight that the number of participants as well as the number of employers are important to determining the costs of the Program. These calculations do not even take into account sunk or fixed recordkeeping costs or any of the other fixed costs of running the program; the lower the number of accounts, the greater these expenses will be on a per-account basis. Understanding the likely opt-out scenarios is critical to being able to determine whether the Program is economically viable.

Figure 4
Higher Opt-Out Rates Increase the Variable Costs of Recordkeeping

Direct servicing model	Number	Per unit cost	Total cost	Cost per participant account
Example #1				
Employers	100,000	$150	$15,000,000	
Participants	1,000,000	$20	$20,000,000	$35
Example #2				
Employers	100,000	$150	$15,000,000	
Participants	100,000	$20	$2,000,000	$170
EDD servicing model	Number	Per unit cost	Total cost	Cost per participant account
Example #3				
Employers	100,000	$120	$12,000,000	
Participants	1,000,000	$17	$17,000,000	$29
Example #4				
Employers	100,000	$120	$12,000,000	
Participants	100,000	$17	$1,700,000	$137

Note: Cost data are for existing employers and participants. Costs would be higher for new employers in the direct servicing model. *See* page 117 in the Report.
Sources: ICI tabulation and Overture Financial Final Report

Figure 5 provides additional numerical examples that highlight how variable recordkeeping costs could be affected depending on the pattern of the opt-out rates across firms even when the same

[25] Examples 3 and 4 in the lower panel of Figure 4 repeat the variable recordkeeping cost exercise using the EDD (State of California Employment Development Department) servicing model.

number of workers open IRAs in the Program (and therefore the aggregate opt-out rate is constant). In the top panel, the variable recordkeeping costs from the direct servicing model are calculated for the scenario where 500,000 workers participate in the Program and open IRAs. These 500,000 workers are employed by 100,000 different employers. The average variable cost of recordkeeping is $50 per participant in this scenario (Example 1). But, what if the 500,000 workers are employed by 300,000 different employers? In this scenario, the average variable cost of recordkeeping rises to $110 per participant (Example 2).[26] This exercise highlights that the number of employers as well as the number of participants are important to determining the costs of the Program.

Figure 5
Different Opt-Out Rates Across Employers Impact the Variable Costs of Recordkeeping

Direct servicing model	Number	Per unit cost	Total cost	Cost per participant account
Example #1				
Employers	100,000	$150	$15,000,000	
Participants	500,000	$20	$10,000,000	$50
Example #2				
Employers	300,000	$150	$45,000,000	
Participants	500,000	$20	$10,000,000	$110
EDD servicing model	**Number**	**Per unit cost**	**Total cost**	**Cost per participant account**
Example #3				
Employers	100,000	$120	$12,000,000	
Participants	500,000	$17	$8,500,000	$41
Example #4				
Employers	300,000	$120	$36,000,000	
Participants	500,000	$17	$8,500,000	$89

Note: Cost data are for existing employers and participants. Costs would be higher for new employers in the direct servicing model. *See* page 117 in the Report.
Sources: ICI tabulation and Overture Financial Final Report

[26] Examples 3 and 4 in the lower panel of Figure 5 repeat the variable recordkeeping cost exercise using the EDD servicing model.

B. If contribution rates are lower than projected, the economic viability to the Program is at risk

The Report finds that contribution rates have a significant impact on Program expenses, the required financing for the Program, and the payoff year. The baseline scenario assumes a 5 percent contribution rate on an average full-time annual salary of $45,000 or an average annual part-time salary of $20,000.[27] Changing the contribution rate to 3 percent raises required financing by $81 million, or 91 percent, extends the payoff year by 3 years, or 50 percent, and increases Program expenses in the first year by 1.61 percentage points, or 51 percent (Figure 6).

Although the Report acknowledges that the contribution rate will have a significant impact on the ultimate financing required, it uses a rate that is higher than the survey results suggest may occur. The Board should consider additional scenarios that include a 2 percent contribution rate, as well as a variety of combinations of contribution rates and opt-out rates.

Figure 6

Financial Feasibility of Program Greatly Impacted by the Contribution Rate

	Required financing ($millions)	Payoff year	Program expenses as a percent of assets		
			Year 1	Year 5	Year 10
(5% contribution rate; 25% opt-out)	$89	6	3.17	0.76	0.45
3% contribution rate	$170	9	4.78	1.07	0.59
Memo:					
Difference	$81	3	1.61	0.31	0.14
% difference	91%	50%	51%	41%	31%

Note: *See* page 118 in the Report.

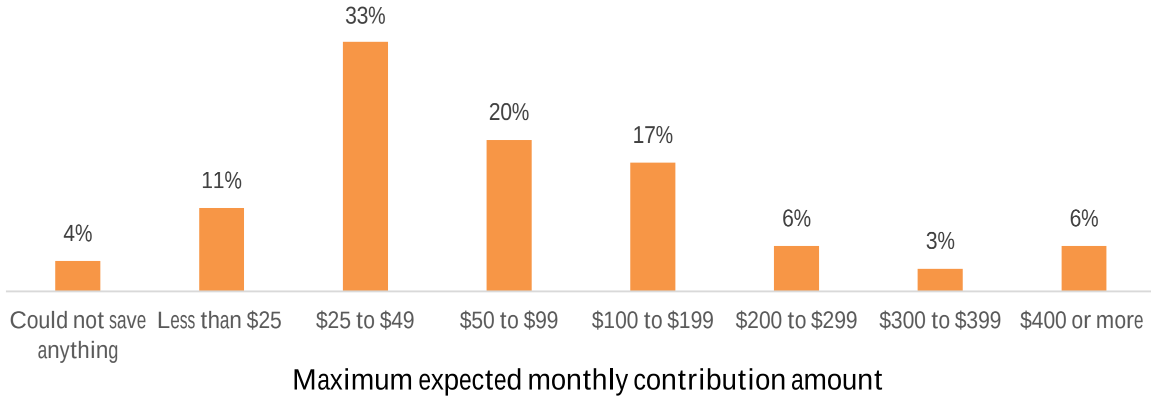
Sources: Investment Company Institute calculations and Overture Financial Final Report

In contrast to the assumed 5 percent contribution rate, the survey results presented in the Report indicate that the majority of eligible workers say they would likely contribute very small amounts into IRAs in the Program. The median maximum expected monthly amount respondents indicated they would likely contribute falls in the $50 to $99 category (Figure 7). Indeed, most eligible workers surveyed said they could contribute to such a program, but 64 percent indicated that the

[27] *See* page 112 in the Report.

maximum they could contribute would be less than $100 a month, including one-third who said the most they could contribute was between $25 and $49 a month.

Figure 7
Eligible Workers Report Possible Contribution Amounts That Are Modest
Percentage of respondents, 2015



Note: Sample is 1,000 respondents; workers not offered retirement plans at work.
Source: Greenwald & Associates Online Survey

Such contribution amounts would generate much smaller accounts than those estimated in the baseline scenario in the feasibility study in the Report. Based on the respondents' maximum likely contributions, the average annual contribution would range from about $1,000 to about $1,700, which is well below the average annual contribution assumed in the feasibility study. The Report projected 1.6 million participants with $3.2 billion in assets after one year, which is an average account of about $2,000.[28]

Corroborating what the survey found with regard to contribution amounts, the wage composition of the uncovered California workers also suggests that many accounts will have only modest contributions. One-fifth of eligible California workers have annual salaries less than $10,000 (Figure 8). Even if the Board were to focus on eligible California workers who are employed full-time and full-year, one-fifth of those workers have annual salaries of $20,151 or less. Given that 57 percent of eligible workers are full-time, full-year (Figure 2), 43 percent are less connected to the workforce and more likely to be lower-income and experiencing financial stresses.

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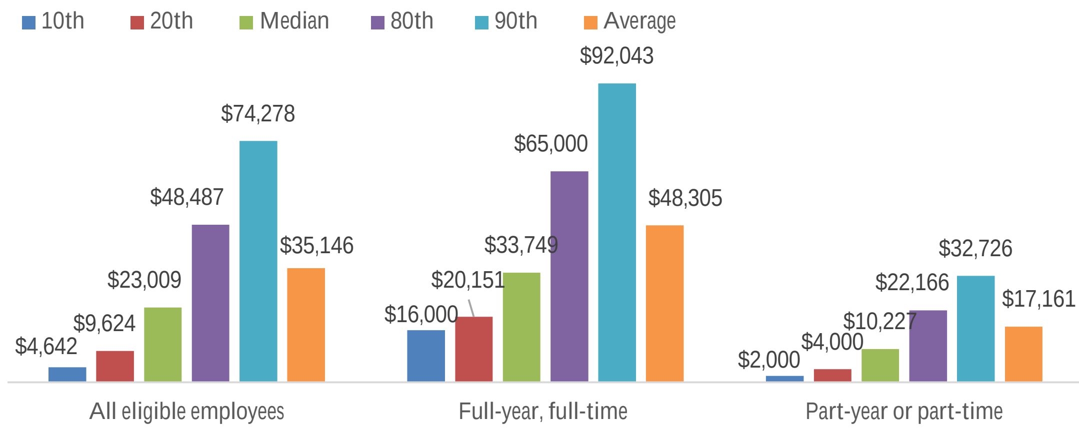
[28] *See* page 114 in the Report.

Figure 8
Wage Distribution of Eligible California Employees
Percentiles and average of annual earnings, 2012–2014



Note: Data for all eligible employees are from Figure C-4 on page 30 of the Report. Data for full-time, full-year, versus part-year or part-time are from Investment Company Institute tabulations of Current Population Survey data. ICI tabulations indicate that 57 percent of eligible California workers are full-time, full-year, and 43 percent are part-time or part-year (see Figure 2 above).
Sources: Overture Financial Final Report and Investment Company Institute tabulations of the Current Population Survey

C. Withdrawal activity and turnover may be higher than assumed in the Report

Because the Program represents an entirely new set of enrollment and participation experiences, it is not possible to extrapolate from private-sector experience with withdrawals and turnover. Additional scenarios should be stress-tested to determine the impact of withdrawals and turnover on the asset growth and costs of the Program, and hence on its financial feasibility. There are several variables that would affect withdrawal activity and turnover: (1) access to account balances for self-certified hardship withdrawals; (2) behavior at job change of participants in a mandatory automatic enrollment program; (3) IRA rules which permit individuals to change financial services providers at any time; and (4) realization by participants that a private-sector IRA may offer a more attractive investment opportunity.

Research on withdrawal activity and rollover and cash-out behaviors at job change or retirement has largely been based on the behavior of participants in retirement plans with voluntary enrollment. Even for plans with automatic enrollment, the employer had the choice to set up automatic enrollment, not the requirement to do so. Moreover, research shows that the availability of plan loans in 401(k) or other DC plans helps contribute to low withdrawal rates while working, because typically a plan participant must take a loan before seeking a withdrawal. Thus, withdrawal rates in employer-sponsored DC plans will not provide insight into the withdrawal activity that might occur in the Program.

One might then consider withdrawal activity among IRA investors, but again, the withdrawal activity among IRA investors who have voluntarily created their IRAs may not provide a good measure of withdrawal activity in the Program.

The Report assumes that worker turnover is the sole factor in determining withdrawals. Linking withdrawal activity solely to worker turnover, however, ignores the fact that participants in the program will also have the ability to change service providers and therefore likely understates the extent of potential participant withdrawals from the Program. The Report indicates that participants will shoulder the start-up and fixed costs of the plan in addition to a 0.18 percent investment management fee. Total participant fees will be capped at 1.00 percent per year, with excess revenue from this fee used to pay back the costs of the Program in the initial years.[29] Effectively, the Program places the burden of start-up costs on participants in the Program, with the promise of eventual lower fees when those start-up costs have been recovered.

It is far from certain these participants will stick with the Program to eventually experience the lower fees. If the Program creates true IRAs, participants may change service providers, or transfer their IRA balances from one service provider to another, at any time.[30] Workers not covered by retirement plans at their current employers have access to the vibrant IRA market, which is served by a range of financial services firms offering a wide variety of investment options.[31] Indeed, 61 percent of traditional IRA–owning household with rollovers indicated that one of the reasons they rolled over the assets from their employer-sponsored retirement plans was to get access to more investment options (with 21 percent saying that was the primary reason they rolled over) and 48 percent rolled over to use a different financial services firm.[32]

Program participants also may realize that they could find a far more attractive deal in the private sector, with additional investment choice, flexibility, and lower-cost options. Private-sector IRA investors are able to obtain lower-cost fund investing and, indeed have concentrated their assets in

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[29] *See* pages 115 and 117 in the Report.

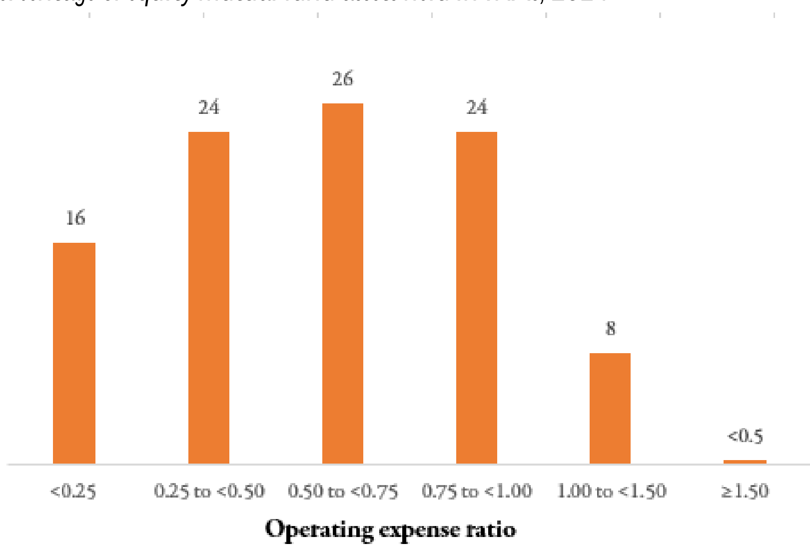
[30] "A transfer of funds in your [IRA] from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. This includes the situation where the current trustee issues a check to the new trustee but gives it to you to deposit. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers." For the rules on IRA transfers, *see* U.S. Department of Treasury, Internal Revenue Service, "Contributions to Individual Retirement Arrangements (IRAs), For use in preparing 2015 Returns," *Publication 590-A*; available at www.irs.gov/pub/irs-pdf/p590a.pdf.

[31] *See* Holden and Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2015," *ICI Research Perspective* 22, no. 1 (February 2016); available at www.ici.org/pdf/per22-01.pdf.

[32] *Id.*

lower-cost mutual funds. For example, at year-end 2014, more than 90 percent of IRA equity mutual fund assets were in equity mutual funds with operating expenses of less than 1.0 percent, including 40 percent with operating expenses less than 0.50 percent (Figure 9).[33] All of these factors could be expected to lead to higher turnover and withdrawal activity than the Board may anticipate.

Figure 9
IRA Investors Concentrate Their Assets in Lower-Cost Mutual Funds
Percentage of equity mutual fund assets held in IRAs, 2014



Note: This figure reports the distribution of equity mutual fund assets held in IRAs by mutual fund operating expenses so as to focus on investment management expenses (rather than total mutual fund expense ratios which would include the 12b-1 fees investors pay through the fund for some or all of the services they receive from financial professionals and other financial intermediaries). The operating expense ratio is reported as a percent of assets. Components do not add to 100 percent because of rounding.
Sources: Investment Company Institute and Lipper

D. Program costs may be higher than projected, which will burden Program participants, California taxpayers, or both

The Report does not appear to have contemplated all the costs of the Program. The Report rightly indicates that "[a]dministering the California Secure Choice Program represents the single

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[33] If one analyzes the distribution of IRA mutual fund assets by total fund expense ratio, it also is clear that IRA investors concentrate their assets in lower-cost mutual funds. *See* "Statement of the Investment Company Institute, Brian Reid, Chief Economist, Hearing on 'Restricting Access to Financial Advice: Evaluating the Costs and Consequences for Working Families and Retirees,' Subcommittee on Health, Employment, Labor, and Pensions Committee on Education and the Workforce, United States House of Representatives" (June 17, 2015); available at www.ici.org/pdf/15_house_advice.pdf.

largest cost item and can be the primary determinant of its financial feasibility."[34] But the analysis does not include enforcement costs,[35] and it is not clear the extent to which it fully considers compliance costs.[36]

Some assumptions on patterns of participation in the Program could have significant impact on the cost of administering the Program. The feasibility exercise, for example, appears to focus on the number of IRAs actually created, but the number of IRAs attempted but not created could also drive costs higher. The Report estimates that "10 percent of [the 6.3 million eligible California participants] would not have a valid Social Security number and so would not participate."[37] Opting those non-participants out of the system could incur processing costs, including the cost of resolving their Social Security number issues. As explained on page 14 in the Report, in the EDD (State of California Employment Development Department) servicing model, the recordkeeper may also need to provide refunds if payroll deduction commences before the recordkeeper resolves the Social Security number issues. In either scenario, the recordkeeper will incur costs related to sorting out the situation with these workers (Figure 10).

[34] *See* page 91 of the Report.

[35] *See* page 113 of the Report.

[36] On page 93, the report states that: "In both models [EDD or direct servicing recordkeeping], EDD runs employer education outreach/campaign and possibly performs compliance and audit functions." It is difficult to figure out where this cost is accounted for on page 117 of the Report, which provides a detailed breakdown of expense drivers. Enforcement, compliance, and audit costs could prove substantial, and their role in the current analysis should be clarified.

[37] *See* page 112 in the Report.

Figure 10
Sorting Out Social Security Issues May Result in Costly Recordkeeping

Topic	Recommendation
Employer Role in Social Security Number (SSN) Validation	**Normal employment eligibility verification process.** **NOTE:** Include requirement for Recordkeeper to accept this as part of the RFP to select Recordkeeper.
Recordkeeper & EE Roles	**Recordkeeper performs electronic validation of identity of new enrollees; contacts EE (not ER) regarding invalid SSN.** Under the Direct Service model, no account is created, and payroll deduction for that EE does not commence until issue is resolved. **EE responsible for taking action to resolve issue** -- correct SSN/name, provide TIN, or opt out—within a 45 day period. **If no resolution or EE opts out, Recordkeeper takes no further action.** Under the EDD-as-Intermediary model, there may be a need for refunds if payroll deduction commences before the Recordkeeper has the opportunity to process SSN issues.

Note: *See* page 14 in the Report.
Source: Overture Financial Final Report

Another problem with the Report is it assumes that workers who are between jobs do not have an impact on Program costs. The Report states that "at any single point in time, about 10 [percent] of full-time workers and 25 [percent] of part-time workers would be in between jobs and not represented on any employer payroll."[38] Even if those estimates are accurate, they do not appear to account for part-year and seasonal workers who will not make periodic contributions throughout the entire year and could end up with smaller balances, which will result in higher per-account costs in the Program.

[38] *See* page 112 in the Report.

The Report also does not appear to consider the full extent of the costs to the Program of developing and delivering participant education or communications to report account activity, account balances, and other matters. Employers provide extensive educational materials about private-sector 401(k) plans through multiple touch points. In the IRA market, financial services firms provide extensive materials about opening and investing in IRAs, and have systems in place to comply with Form 5498 and 1099-R reporting requirements. As an entirely new program involving mandatory automatic enrollment, the Program will require extensive educational materials and multiple communication channels to explain the Program to employers and workers. The cost of such materials, initially and on an ongoing basis, needs to be fully incorporated into the feasibility analysis. The Report indicates that education and communication materials will be developed by EDD and the recordkeeper, with "EDD collaborat[ing] on employer outreach and training,"[39] but the Report does not clearly spell out the extent to which costs associated with education and communication materials for both employers and employees have been incorporated into the feasibility study.[40] Any incorrect estimate of the cost of creating and maintaining these materials, communication channels, and reporting systems would impact the financial feasibility of the Program.

II. Many Workers Not Covered by Employer-Sponsored Retirement Plans Have Other, More Pressing Financial Needs

In addition to concerns about the accuracy of the Report's findings and financial viability of the Program, we believe that it is important for the Board to appreciate that—in contrast to a fundamental assumption underlying the perceived need for mandatory state-run retirement plans —workers currently not covered by employer-sponsored retirement plans may not be best served by automatic enrollment into such programs. In this respect, analysis of the data on retirement plan coverage suggests that workers not currently covered by retirement plans tend to have other, more pressing financial needs or savings goals. The Board should be thoughtful about potentially causing inadvertent harm to workers who fail to opt out but really cannot afford to contribute to the plan.[41] Analysis of household

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[39] *See* page 100 in the Report.

[40] *See* page 117 in the Report. Expenses for call centers, contribution processing and "marketing" are listed; but it is not clear how the estimates were arrived at or the extent to which the development and maintenance of educational and communication materials (for both employers and employees) has been fully captured.

[41] Significantly, in the notice accompanying its proposed safe harbor regarding state plan programs, DOL mentions that such inadvertent savings could cause damage to the overall household balance sheet if, for example, debt were incurred or not paid down. DOL mentions the possibility that a college student might reasonably focus on paying down student loans and a young family might focus on saving for education. 80 Fed. Reg. 72012. Household survey data from the Survey of Consumer Finances provide evidence that there is a life cycle of saving: Households tend to focus on building education, a family, or money to purchase a home earlier in life, before focusing on saving for retirement later in life; *see* Figure 1 in Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014), available at www.ici.org/pdf/per20-06.pdf; *see also* Figure 7.2 in Investment Company Institute, *2015 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry* (2015), available at www.icifactbook.org. In addition, the Federal Reserve Bank of New York Consumer Credit Panel data indicate that in 2015:Q4, student loan debt

balance sheet data indicates that households without retirement accumulations tend to face significant and immediate pressing financial stresses, which would only be heightened if they are automatically enrolled into these plans and a portion of their wage income is set aside into a retirement savings account.

A. The Report does not reflect the complexity of factors associated with retirement plan coverage or the potential for economic harm to workers

Discussions about retirement plan coverage often rely on misleading or incomplete coverage statistics. The Institute has published extensive research on the difficulties that arise in determining the scope of retirement plan coverage. The most commonly used data understate retirement plan coverage,[42] and the most commonly used measure—a snapshot of coverage at a single point in time across workers of all ages, incomes, and degrees of attachment to the workforce—is not a good

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was $1.2 trillion, which is larger than the $0.7 trillion in credit card debt and the $1.1 trillion in auto loan debt. *See* Federal Reserve Bank of New York, The Center for Microeconomic Data, *Consumer Credit Panel, Household Debt & Credit*, "2015:Q4 Data;" available at www.newyorkfed.org/microeconomics/data.html. Federal Reserve Board researchers note that "[t]he level of education loan debt held by U.S. families has increased dramatically over the past decade;" *see* page 26 in Bricker et al., "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 100, no. 4 (September 2014); available at www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf. They also analyze how education debt burden varies across households.

[42] The most commonly used data to analyze retirement plan coverage is the Current Population Survey (CPS), which is a household survey. The CPS typically shows lower rates of pension coverage than surveys of business establishments, such as the National Compensation Survey (NCS). For example, the CPS data show that 59 percent of all full-time, full-year private-sector wage and salary workers had pension coverage in 2013 (pension coverage includes DB and/or DC plans; ICI tabulations of 2014 CPS data). The March 2014 NCS, on the other hand, shows that 65 percent of all private-industry workers and 74 percent of all full-time private-industry workers had access to a pension. *See* Table 1 in U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in the United States—March 2014," *News Release* USDL-14-1348 (July 25, 2014); available at www.bls.gov/ncs/ebs/sp/ebnr0020.pdf. The March 2015 NCS reports that 66 percent of all private-industry workers and 76 percent of all full-time private-industry workers had access to a pension. *See* U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in the United States—March 2015," *News Release* USDL-15-1432 (July 24, 2015); available at www.bls.gov/news.release/pdf/ebs2.pdf.

The analysis in Figure 11 uses the March 2014 CPS data which provide insight into benefits available in 2013. The CPS, which tends to understate retirement plan coverage, changed the survey in March 2015 and the survey changes inadvertently impacted the retirement plan coverage question responses. The March 2015 CPS data for 2014 find that retirement plan coverage dropped in 2014, particularly among the groups of workers most likely to have retirement plans at work. Copeland (2015) concludes that "[t]he unexplainable decreases in the participation level after the CPS redesign and the conflicting time series of the participation levels in CPS relative to other surveys raise doubts about the use of CPS data to assess future retirement plan coverage policies." *See* Copeland, "The Effect of the Current Population Survey Redesign on Retirement-Plan Participation Estimates," *EBRI Notes* 36, no. 12, Washington, DC: Employee Benefit Research Institute (December 2015): 1–11; available at www.ebri.org/pdf/notespdf/EBRI_Notes_12_Dec15_CPS-WBS.pdf.

indicator.[43] It is important to understand the typical characteristics of the workers at employers that do not offer plans in order to formulate effective solutions to increasing coverage among the minority of workers who are without access.

As explained below, the majority of private-sector workers without employer-sponsored retirement plan coverage are younger, lower-income, or less connected to the workforce. This is the case whether the data are examined for the nation as a whole, or for the State of California. As a result, many of these workers may face financial stresses and savings priorities more pressing than retirement saving.

B. Workers not currently participating in retirement plans at work may have other, more pressing financial priorities

Without a doubt, inadequate retirement savings can affect a retiree's ability to meet basic needs, such as needs for food, housing, health care, and transportation. For many workers not covered by employer-sponsored retirement plans, the difficulty in meeting these basic needs does not begin in retirement, but occurs during their working years as well. Workers not currently covered by employer-sponsored retirement plans—who tend to be younger, lower-income, or less connected to the workforce—may have other, more immediate savings priorities. Part-time employment in particular may be a signal of financial stress.

In its proposed ERISA safe harbor regulation, DOL notes that the state initiatives might have some unintended consequences for such workers, explaining:

> Workers who would not benefit from increased retirement savings could opt out, but some might fail to do so. Such workers might increase their savings too much, unduly sacrificing current economic needs. Consequently they might be more likely to cash out early and suffer tax losses, and/or to take on more expensive debt. Similarly, state initiatives directed at workers who do not currently participate in workplace savings arrangements may be imperfectly targeted to address gaps in retirement security. For example, a college student might be better advised to take less in student loans rather

[43] The most commonly used measure to judge retirement plan coverage is a snapshot of coverage at workers' current employers across the entire private-sector workforce. This measure is a poor indicator of whether households will have retirement plan coverage at some point over their lifetimes and approach retirement with retirement accumulations. If this snapshot measure is refined to take into consideration the lifecycle of saving, to recognize the role that Social Security plays in replacing lifetime wage income for lower-income households, and to account for the degree of connection to the workforce—it is clear that the majority of private-sector workers most likely to contribute to an employer-sponsored retirement plan have pension plan coverage as part of their compensation. *See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf. Put another way, the number of private-sector workers who are likely to be focused on saving for retirement but do not have access to an employer-sponsored retirement plan is lower than suggested by a cursory look at the aggregate data.

> than open an IRA, and a young family might do well to save more first for their children's education and later for their own retirement.[44]

As important as retirement savings is, DOL is correct to point out that these workers may have other priorities for take-home pay. The data suggest that about three-quarters of private-sector workers without retirement plan coverage may be focused on other savings goals or experiencing other financial stresses. The policy rationale underlying the state initiatives does not give adequate consideration to the fact that lack of retirement savings is not the beginning of the financial difficulties for many of these individuals. It also does not give due regard to the important resource that Social Security plays in replacing earnings for U.S. retirees, particularly lower-income workers, who get high earnings replacement rates from Social Security.[45]

A substantial portion of private-sector workers not currently covered by retirement plans at work may face immediate financial stresses. Among the 50.6 million private-sector wage and salary workers aged 21 to 64 who work for employers that do not sponsor retirement plans, nearly four in 10 (39 percent) work only part-time or part-year (Figure 11).

Part-time or part-year work in a given year may be an indicator of financial stress, whether it is a long-term or temporary situation. If these workers usually work part-time or part-year, they are less likely to have additional disposable income to reduce their current consumption to save for retirement, because the vast majority of part-time, part-year workers have low earnings.[46] As low lifetime earners, these workers likely will receive a high earnings replacement rate from Social Security.[47] If some of these workers who are currently working part-time or part-year usually work full-time or for a full year, then earnings in the current year likely are below their typical earnings, and these individuals are unlikely to want to reduce current consumption further by saving—for retirement or for any reason. In either case, part-time, part-year workers are unlikely to be focused on saving for retirement in the current year.

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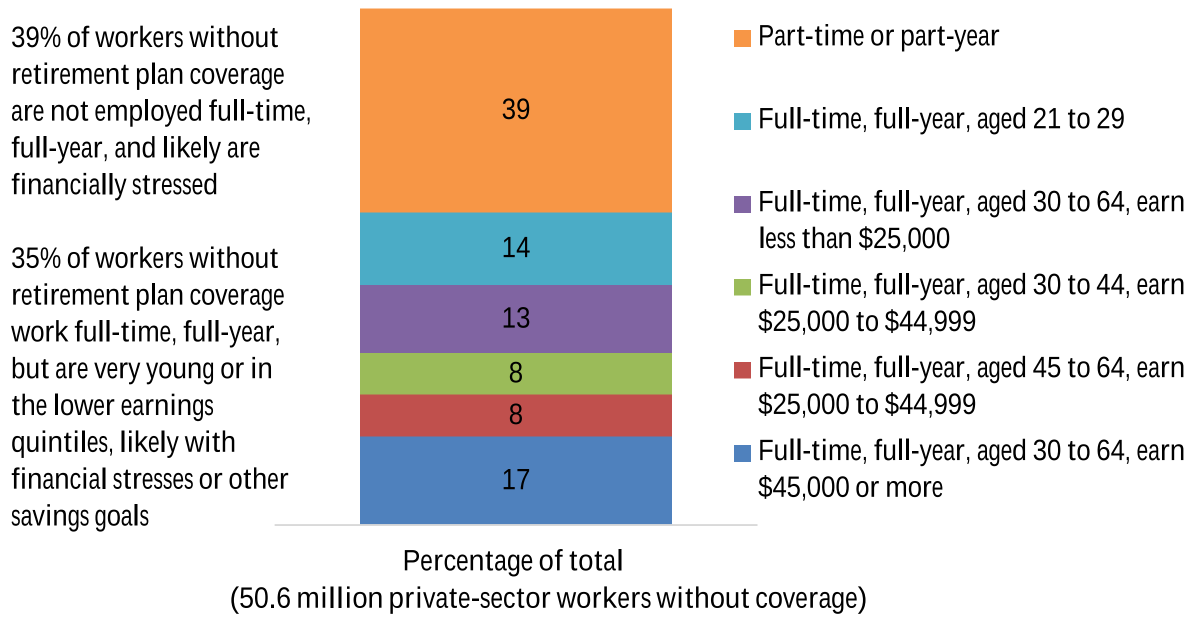
[44] 80 Fed. Reg. 72012.

[45] The Congressional Budget Office reports estimated replacement rates from scheduled Social Security payments, and Social Security replaces a higher percentage of pre-retirement earnings for workers in lower-income households than it does for workers in higher-income households. *See* Congressional Budget Office, *CBO's 2015 Long-Term Projections for Social Security: Additional Information* (December 2015); available at www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51047-SSUpdate.pdf.

[46] *See* Tables 41 and 42 in Brady and Bogdan "Supplemental Tables for Who Gets Retirement Plans and Why, 2013;" available at www.ici.org/info/per20-06_data.xls.

[47] *See* note 45.

Figure 11
About Three-Quarters of Workers Without Retirement Plan Coverage Likely Have Other Financial Priorities
Percentage of private-sector wage and salary workers, aged 21 to 64, whose employers do not sponsor a retirement plan, 2013



Note: Components do not add to 100 percent because of rounding. *See* Figure 6 in the research paper for additional detail.
Source: Investment Company Institute tabulations of March 2014 Current Population Survey; *see* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014)

Another 35 percent of private-sector workers without retirement plan coverage at work are very young or lower earners (Figure 11), which suggests they may well have other savings goals, have less need to supplement Social Security benefits, or have other financial stresses. Of this 35 percent, the 14 percent who are full-time, full-year but aged 21 to 29 are likely to be saving for other goals, such as a home, for the family, or education.[48] The primary concern for the 13 percent of full-time, full-year

[48] According to 2013 Survey of Consumer Finances data, 32 percent of households with head of household aged 21 to 29 indicate that saving for home purchase, the family, or education is their primary savings goal, while only 13 percent of such young households report that retirement is their primary savings goal. *See* Figure 7.2 in Investment Company Institute, *2015 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry* (2015); available at www.icifactbook.org. Household education loan debt has grown in recent years; *see* discussion in note 41.

private-sector workers aged 30 to 64 earning less than $25,000 per year more likely will be that they do not have enough to spend on such immediate needs as food, clothing, and shelter. In fact, many are eligible for government income assistance so that they will be able to spend more than what they earn on these items. If these workers consistently have low earnings throughout their careers, Social Security will replace a high percentage of their lifetime earnings, allowing these workers to use more of their wage income to meet current needs and allowing them to delay additional saving for retirement.[49] The remaining 8 percent of private-sector workers age 30 to 44 who earn between $25,000 and $44,999 a year may have the ability to save, but may have other saving priorities, such as starting a household and providing for the needs of their children. Given that they get a substantial replacement rate from Social Security, they are likely to delay saving for retirement until later in life.[50]

Analysis of household balance sheet data indicates that households without retirement accumulations are more likely to face significant and immediate pressing financial stresses compared with those with retirement accumulations. Focusing on older households who have had much of a lifetime to address retirement savings needs, the data show that those without retirement accumulations tend to have indicators of financial stress.

Figure 12 examines older households—those with a head aged 55 to 64, whether working or not—by their retirement accumulation status. Retirement accumulations can be in the form of DC plans, IRAs, or defined benefit (DB) plan benefits. Older households without retirement accumulations are more likely to report that they received income from public assistance: 35 percent of households without retirement accumulations, compared with 4 percent with retirement accumulations. Older households without retirement accumulations are more likely to be lower income: 52 percent are in the lowest per capita household income quintile, compared with 8 percent of households with retirement accumulations. More than one-quarter (27 percent) of older households without retirement accumulations have no health insurance and almost one-quarter (23 percent) do not have checking accounts. All told, 76 percent of older households without retirement accumulations face at least one of these financial stresses, compared with only 20 percent of households with retirement accumulations.

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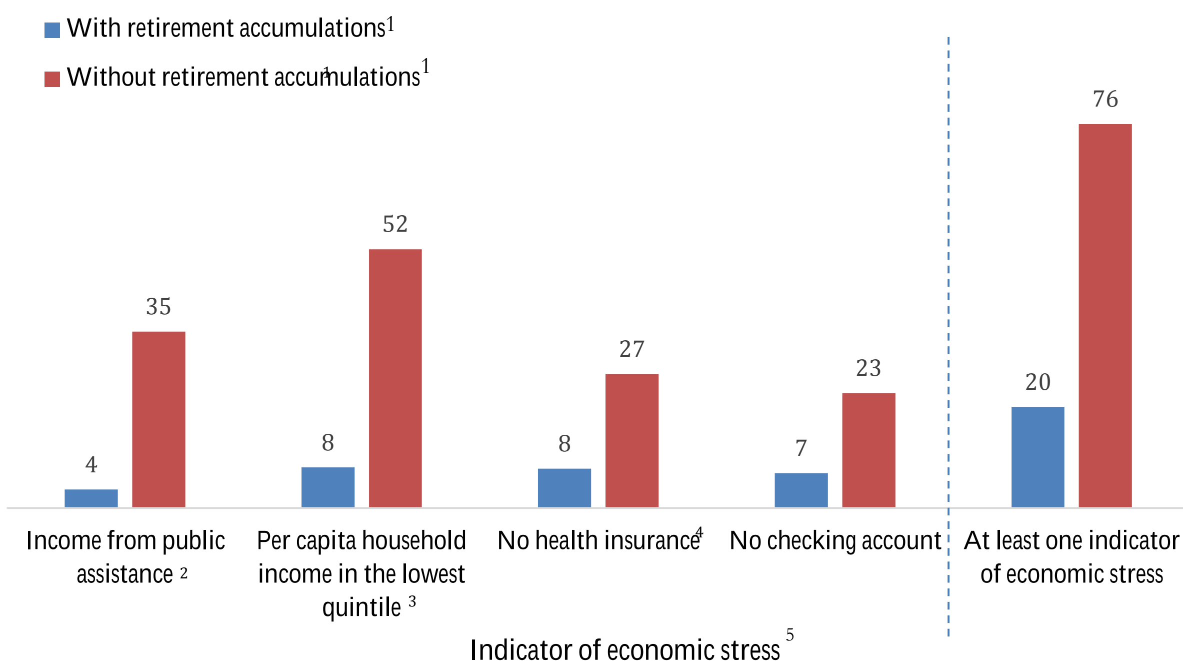
[49] For a simulation exercise that explores the relationship and timing of 401(k) plan saving taking into account the role that Social Security plays for American workers in preparing for retirement, *see* Brady, "Who Benefits from the U.S. Retirement System," *ICI Research Perspective* 21, no. 7 (November 2015); available at www.ici.org/pdf/per21-07.pdf.

[50] *See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf and Tables 41 and 42 in Brady and Bogdan, "Supplemental Tables for Who Gets Retirement Plans and Why, 2013;" available at www.ici.org/info/per20-06_data.xls.

Figure 12
Older Households Without Retirement Accumulations Tend to Have Financial Stresses
Percentage of U.S. households aged 55 to 64 by retirement accumulation status, 2013



[1] Retirement accumulations include retirement assets and DB benefits. Retirement assets include DC plan assets (401(k), 403(b), 457, thrift, and other DC plans) and IRAs (traditional, Roth, SEP, SAR-SEP, and SIMPLE), whether from private-sector or government employers. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits, whether from private-sector or government employers.
[2] Income from public assistance includes TANF, SNAP, and other forms of welfare or assistance such as SSI.
[3] Households with a head aged 55 to 64 at the time of the survey were ranked by per capita household income before taxes in 2012.
[4] No health insurance indicates that no individual in the household had public or private health insurance.
[5] Households may fall into multiple categories.
Note: The sample represents 23.0 million households with head of household aged 55 to 64 in 2013; 73 percent had retirement accumulations and 27 percent did not.
Source: Investment Company Institute tabulations of 2013 Survey of Consumer Finances

C. Workers have access to many tax-advantaged retirement savings opportunities

It is certainly essential that workers have easy access to tax-advantaged retirement savings opportunities to supplement the broad-base of the Social Security system. This premise has served as the foundation for the strong voluntary U.S. retirement system. Millions of workers in California have such access already through employer-sponsored retirement plans. For those without employer-sponsored retirement plans, access is available through traditional IRAs (since 1974), Roth IRAs (since

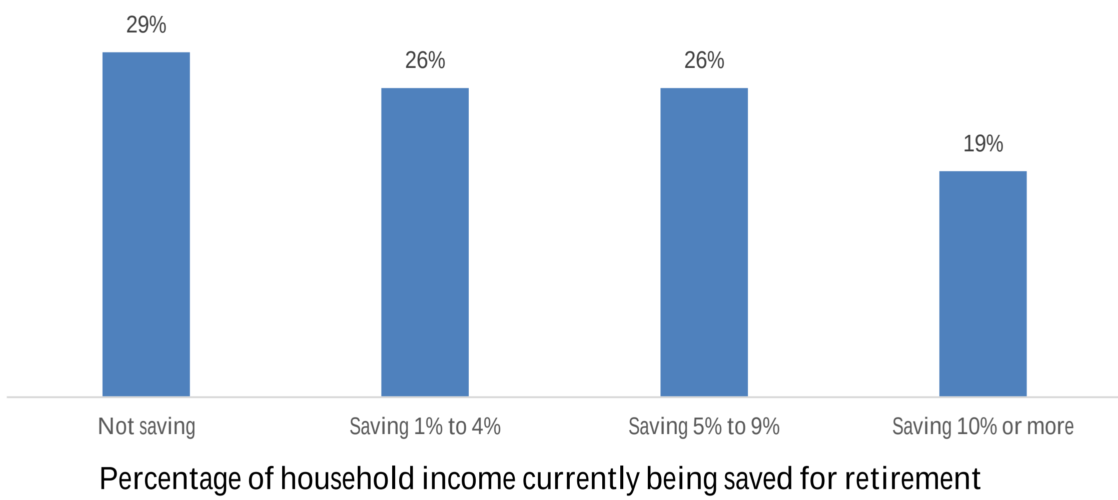
1998), and myRAs (since November 2015). Traditional and Roth IRAs can easily be opened through a variety of avenues—whether through investment professionals or directly with a mutual fund company or discount broker—and myRA is available online.[51] As federal options, these different IRAs are available to workers across the country, regardless of state of residence or changes in state of residence.

Thus, before the State of California embarks on creating another plan, it should remember that such access exists for the more than 6 million California workers who do not have employer-sponsored retirement plans at their current jobs. Indeed, the Report indicates that 71 percent of eligible workers were saving for retirement already, with 45 percent indicating they were saving 5 percent or more for retirement (Figure 13). Many even may be saving in an employer-sponsored retirement plan, as Current Population Survey (CPS) data indicate that about 10 percent of uncovered California workers have a spouse whose employer offers a plan.[52]

[51] Traditional IRA–owning households surveyed in mid-2015 report that 80 percent of traditional IRA–owning households hold traditional IRAs through investment professionals such as full-service brokerages, independent financial planning firms, banks or savings institutions, or insurance companies, and 33 percent hold traditional IRAs directly through mutual fund companies or discount brokerages (households may have multiple traditional IRAs). *See* Holden and Schrass, "Appendix: Additional Data on IRA Ownership in 2015." *ICI Research Perspective* 22, no. 1A (February 2016); available at www.ici.org/pdf/per22-01a.pdf. In addition, firms and individuals interested in the myRA can learn more and set up accounts at https://myra.gov.

[52] ICI tabulation of the same sample studied in the Report, which represents 6.8 million California workers without employer-sponsored retirement plan coverage at their current jobs, 2012–2014.

Figure 13
Majority of Uncovered Workers Already Are Saving for Retirement
Percentage of respondents, 2015



Note: Sample is 1,000 respondents; workers not offered retirement plans at work.
Source: Greenwald & Associates Online Survey

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The Board must engage in further study before taking any action to recommend moving forward with the Program. Analysis of the data provides reasons to believe that the Program will not be as effective at increasing retirement plan participation and savings in California as the Report assumes. The Program is dramatically different than the voluntary retirement plan system in which automatic enrollment has been so successful. The Report likely underestimates the true costs of setting up and running the Program and would benefit from deeper analysis of scenarios that consider the impact of higher opt-out rates, variation in opt-out rates across employers, lower contribution rates, higher levels of withdrawal and turnover activity, and more comprehensive cost estimates.

In addition, the Institute believes strongly that policies that cooperate with, rather than coerce, employers, who best know the demographics and needs of their workers, present far more efficient and effective solutions for expanding coverage.

We hope you find the foregoing comments helpful to your consideration of the Report. If you need additional information or you have questions regarding our comments, please feel free to contact me at (202) 326-5815 or david.blass@ici.org; Sarah Holden, Senior Director, Retirement and Investor Research, at (202) 326-5915 or sholden@ici.org; or David Abbey, Deputy General Counsel – Retirement Policy, at (202) 326-5920 or david.abbey@ici.org. We welcome the opportunity to discuss these comments further or to provide additional information to you and your staff as you work on this important issue.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel