PENSION SIMPLIFICATION AND INVESTMENT RULES

JOINT HEARINGS

BEFORE THE

SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS

OF THE

COMMITTEE ON FINANCE

AND THE

SELECT COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 285

TO PROTECT PRIVATE PENSION PLAN PARTICIPANTS FROM EXCESSIVE CONCENTRATION OF THE INVESTMENT OF TAX-EXEMPT PRIVATE PENSION ASSETS IN A SMALL NUMBER OF CORPORATE STOCKS BY AMENDING THE INTERNAL REVENUE CODE OF 1954 TO IMPOSE REASONABLE INVESTMENT LIMITATIONS ON LARGE PENSION MANAGERS

AND

S. 901

TO MAKE IT EASIER TO COMPLY WITH CERTAIN FEDERAL EMPLOYEE BENEFIT PLAN REQUIREMENTS BY AMENDING THE INTERNAL REVENUE CODE OF 1954 AND THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 TO ELIMINATE DUAL TREASURY AND LABOR DEPARTMENT JURISDICTION OVER CERTAIN REQUIREMENTS, TO REDUCE THE NUMBER OF REPORTS AND OTHER PAPERWORK REQUIRED THEREUNDER, AND FOR OTHER PURPOSES

MAY 10, 11, 24, 25, JUNE 28, AND JULY 18, 1977

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PENSION SIMPLIFICATION AND INVESTMENT RULES

TUESDAY, MAY 10, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
OF THE COMMITTEE ON FINANCE AND THE
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m. in room 2221, Dirksen Senate Office Building, Hon. Gaylord Nelson and Lloyd Bentsen presiding.

Present: Senators Nelson, Bentsen, Matsunaga, Curtis, and Packwood.

Senator BENTSEN. The hearings will come to order.

This afternoon the Senate Finance Committee's Private Pension Subcommittee, which I chair, and Senate Small Business Committee, chaired by Senator Nelson, begin a series of joint hearings to formulate ways to reduce excessive paperwork and redtape under the 1974 Pension Reform Act and ways to insure that pension investments do not impose unnecessary obstacles to economic growth. These hearings will focus on two bills I have introduced—the Pension Simplification Act (S. 901) and the Pension Investment Act (S. 285). In particular, we will be looking at the impact of pension laws and pension investment policy on smaller businesses.

We are very pleased to have as our lead off witnesses this afternoon, three outstanding administration officials—Assistant Secretary of the Treasury Laurence Woodworth, Assistant Secretary of Labor Francis Burkhardt and the Associate Solicitor of the Labor Department, Steven Sacher. Over the years, in his previous capacity as Chief of Staff of the Joint Tax Committee, Larry Woodworth has provided invaluable assistance to the members of the Senate Finance Committee and House Ways and Means Committee in enacting all tax and pension laws. The President could not have selected a more qualified individual to serve as Assistant Secretary for Tax Policy. We also welcome two dedicated Labor Department officials who share the concern of all Members of Congress in the need to simplify ERISA.

Many good pension plans, particularly for smaller businesses, have been forced to terminate because of duplicate Government reporting requirements, and a snarl of redtape. Dual enforcement of the pension reform law by two different Government agencies—the Labor Department and the Treasury Department—has resulted in a bureaucratic nightmare. The cost of administering pension plans have skyrocketed and delays have stretched out. The cost of administering one pension plan, with 19 participants, rose by almost half in the year after the law went into effect. It took Labor and IRS 26 months to agree on the procedure for handling exemptions from one provision in the law and 29 months after the law was signed only 12 out of 600 exemptions had been granted.

To help remedy this problem, I have introduced the Pension Simplification Act which would divide jurisdiction for enforcement between Labor and IRS to minimize the overlap. Under the proposal the IRS would have complete jurisdiction over vesting, participation and funding requirements, while the Labor Department would be given exclusive jurisdiction over fiduciary responsibility and prohibited transactions.

I have also introduced the Pension Investment Act which would modify the so-called "prudent man rule" in the pension law to prevent the rule from continuing to artificially discourage investments in new and expanding smaller companies.

It is essential that Congress and the administration take prompt action to alleviate these problems. This will require the cooperation of the Departments of Labor and Treasury, the two tax-writing committees in Congress and the two Labor Committees.

The purpose of these hearings is to begin that effort.

Senator Nelson will arrive shortly and his statement will be inserted in the record at this point.

[Statement of Senator Nelson follows:]

OPENING STATEMENT OF SENATOR GAYLORD NELSON

The hearings about to begin constitute a continuation of the joint inquiry of the Small Business Committee and the Subcommittees on Private Pension Plans and Financial Markets of the Senate Finance Committee on the impact of the Employee Retirement Income Security Act (ERISA) on the business community, and particularly small business.

ERISA, which is also known as the Pension Reform Act of 1974, had the worthy objective of strengthening the retirement security of the approximately 50% of U.S. workers who are covered by private pension plans. Since more than 97% of the business community can be classified as "small business," it is not surprising that the statistics show that 96½% of pension plans have less than 100 participants and 93% have 25 or less.

Accordingly, the major requirements for change under this landmark legislation fell upon smaller employers who had chosen to make financial contributions toward future financial security for themselves and for their employees.

Our investigation began during 1975, when it became apparent that problems were arising in the implementation of the law, and especially in the paperwork burdens involved in reporting of information to the several departments and agencies administering ERISA. This culmination on November 18, 1975, in a joint letter from the Chairman of the Finance Committee (Senator Long), the Chairman of the Financial Markets Subcommittee (Senator Bentsen), and the Chairman of the Select Committee on Small Business and the Private Pension Plans Subcommittee (myself) addressed to the Department of Labor and the Internal Revenue Service.

In this letter we made a number of specific requests to simplify and reduce the size of the description and annual report forms that businesses would have been required to fill out; to eliminate the requirement for an accountant's opinion; and to extend the unreasonably short periods of public comment and evaluation. It was gratifying that in December of 1975, these requests were substantially granted. In fact, the proposed EBS-1 form was reduced from 16 to 6 pages and the annual report/return (5500) was cut from 5½ to 2⅓ pages.

To monitor these developments and to examine the trends in pension plan creations and terminations under ERISA, joint hearings of these committees were conducted on February 2 and 3, 1976. Testimony was taken from a broad spectrum of administration and small business witnesses, including those who provided professional services to smaller pension and retirement plans.

On the basis of these proceedings, and our continuing research, the Committee provided the Senate with an interim report on September 30, 1976 (daily Congressional Record, p. S 17393). The report revealed that formation of new pension plans had dropped from about 60,000 in 1973 and 1974 to about one-half of that level in 1975 and 1976. The number of applications for terminations also rose steeply in the years following the Act.

In other words, the ratio between the creation and termination of pension plans fell from a range of 13- or 16-to-1 prior to ERISA to a ratio of 3.7-to-1 in 1975 and 1.2-to-1 for the first 9 months of 1976.

We hope that these hearings will update and refine these statistics and that we will receive a thorough analysis of the reason underlying these trends.

Senator Bentsen and I have expressed deep concern about these developments. We are particularly worried about the termination of private pension retirement plans that would be considered sound in every respect but may have been terminated because of compliance, administrative or paperwork burdens of the Act.

Beyond this, although many Congressional committees, government agencies and private organizations have examined various aspects of the Pension Reform Act, there has been virtually no discussion about how the investment policies will affect the structure of our economy and society. We hope in these hearings to learn of the impact of investment policies governing the $445.4 billion in pension assets (as of December 31, 1976). We would like to know more about the effects of these policies upon capital markets, on opportunities for the creation of new ventures, on productivity, the present and potential competitiveness and efficiency of American industry, employment, and other trends in the labor market. We are beginning to realize also that the investment policies, as well as the administration of these laws, will affect the quality of life for the 30 million people currenty receiving retirement benefits, as well as the millions of our citizens who will advance to retirement age in years to come.

We have been acutely aware of the criticisms by small business relating to administrative requirements under the Act, the structure under which multiple federal departments and agencies are implementing the reform law, the duplicative reporting requirements, and some of the substantive features of the law.

Considering the magnitude of these problems and their significance to our economy and society, we are reminded of the words of President Lincoln that:

"The occasion is piled high with difficulty, and we must rise with the occasion * * * we must think anew and act anew."

It is a source of pride, however, that our committees have taken the lead in exploring the problems under ERISA and in attempting to resolve them.

These hearings are additional evidence that the Congress is ready to review its work and experience of the past 2½ years in the pension field, in order to grapple with the legislative and administrative problems. Hopefully, we advance the process of working out ultimate solutions.

Senator Bentsen has prepared two bills, S. 901 and S. 285, which are before us. These will serve as vehicles for the discussion of the general questions involved and the alternative courses of action.

We very much look forward to receiving the testimony of eminently qualified witnesses which are to appear before us in the next weeks and months. We pledge the full cooperation of the Senate Small Business Committee in this important work.

I ask unanimous consent that the announcement of these hearings (which appeared in the Congressional Record of May 9, 1977, p. S 7237) be inserted in the record of these proceedings for informational purposes.

Senator BENTSEN. At this point in the record, I will include copies of S. 285 and S. 901 and a statement describing the legislation and the committee press releases announcing these hearings.

[The material to be furnished follows. Oral testimony continues on p. 29.]

PRESS RELEASE

FINANCE SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS AND THE SELECT COMMITTEE ON SMALL BUSINESS SETS HEARINGS ON PENSION SIMPLIFICATION PROPOSAL AND PENSION INVESTMENT RULES

The Honorable Senator Lloyd Bentsen (D., Tex.), Chairman of the Subcommittee on Private Pension Plans and Employee Fringe Benefits, announced today that the Subcommittee and the Senate Select Committee on Small Business, chaired by Senator Gaylord Nelson (D., Wis.), will hold joint hearings on S.901, the Pension Simplification Act., and S.285, the Tax-Exempt Private Pension Investment Act of 1977. Initial hearing dates are Tuesday, May 10, 1977, at 2:00 p.m. in Room 2221 of the Dirksen Senate Office Building and Wednesday, May 11, 1977, at 10:00 a.m. Additional hearings will be held in June with the dates to be announced at a later time. The witnesses are as follows:

Tuesday, May 10, 1977.—Dr. Laurence N. Woodworth, Assistant Secretary of Treasury; Frank Burhardt, Assistant Secretary of Labor; Steven J. Sacher, Associate Solicitor of Labor Department.

Wednesday, May 11, 1977.—Donald Alexander, former Commissioner of Internal Revenue; William Chadwick, former Administrator of Pension and Welfare Benefits Programs, Department of Labor; Richard Fay, Washington, D.C.

Panel—David Morgenthaler, Cleveland; Richard Hanschen, Dallas; Reid Dennis, Menlo Park, Calif.; and Steward Greenfield, Darien, Conn.

Senator Bentsen said dual enforcement of the pension reform law by two competing government agencies has created a bureaucratic nightmare, causing pension plan costs to skyrocket and entangling many plans in a snarl of red tape. "We've got two government agencies—the Internal Revenue Service and the Labor Department—each trying to outdo the other in the demands they make under the pension reform law," Bentsen said.

"Businessmen, labor unions and others who operate private pension plans are ordered to file one report giving information to the Labor Department, then turn around and give the same information in another report to the IRS."

"Costs have skyrocketed and delays have stretched out. The cost of administering one pension plan, with 19 participants, rose by almost half in the year after the law went into effect. It took Labor and IRS 26 months to agree on the procedure for handling exemptions from one provision in the law and 29 months after the law was signed only 12 out of 600 exemptions have been granted," the Senator said.

The Pension Simplification Act (S.901) would divide jurisdiction for enforcement between Labor and IRS to minimize the overlap. Under the proposal—which follows generally the original Senate version of the pension bill—the IRS would have complete jurisdiction over participation and funding requirements, while the Labor Department would be given exclusive jurisdiction over fiduciary responsibility and prohibited transactions.

In addition to the pension simplification bill, the hearings will also consider the Tax-Exempt Private Pension Investment Act (S.285) introduced by Bentsen. This would modify the so-called prudent man rule in the pension law to prevent the rule from continuing to artificially discourage pension investments in new and expanding smaller companies. "My primary concern is with efforts to simplify the pension law. At present, American workers are being made to pay in two ways: higher costs for administering their pension benefits and higher taxes to support two identical teams of government pension exports," Bentsen said.

"This must be stopped," Senator Bentsen said.

PRESS RELEASE

FINANCE SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS AND THE SELECT COMMITTEE ON SMALL BUSINESS ANNOUNCES FURTHER HEARINGS ON PENSION SIMPLIFICATION PROPOSAL AND PENSION INVESTMENT RULES

Senator Lloyd Bentsen (D., Tex.), Chairman of the Pension Subcommittee, today said witnesses from two government agencies agreed at hearings this week that dual enforcement of the pension reform law has proven costly and led to lengthy, unnecessary delays.

Bentsen announced that joint hearings he is chairing with Senator Gaylord Nelson, Chairman of the Small Business Committee, into problems with the 1974 pension law, will continue May 24 and 25 at 10:00 a.m. in room 2221 Dirksen Senate Office Building.

"During the first two days of hearings this week we heard some disturbing stories about the delays and costs that have resulted from dual enforcement of provisions of the pension reform law by the Internal Revenue Service and the Labor Department," Bentsen said.

"We were told of the managers of one pension plan who were instructed by the IRS to follow a certain procedure only to be told by the Labor Department that the procedure was wrong and the application in question would have to be resubmitted.

"I am pleased that witnesses representing both the Internal Revenue Service and the Labor Department agreed, in general, with the concept of my bill during testimony at the hearings this week," Bentsen said.

"I am hopeful we can move swiftly toward final approval of the measure once the hearings are completed," Senator Bentsen said.

REQUESTS TO TESTIFY

Senators Bentsen and Nelson advised that witnesses desiring to testify during these hearings on S.285 and S.901 must submit their requests to Michael Stern, Staff Director, Committee on Finance, 2227 Dirksen Senate Office Building, Washington, D.C. 10510, not later than 12, Friday, May 20, 1977. Witnesses will be notified as soon as possible after this cutoff date as to whether they are scheduled to appear. If for some reason the witness is unable to appear as scheduled, he may file a written statement for the record of the hearing in lieu of a personal appearance.

CONSOLIDATED TESTIMONY

Senators Bentsen and Nelson also stated that the Committees urge all witnesses who have a common position or with the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committees. This procedure will enable the Committees to receive a wider expression of views than it might otherwise obtain. All witnesses should exert a maximum effort, taking into account the limited advance notice, to consolidate and coordinate their statements.

LEGISLATIVE REORGANIZATION ACT

Senators Bentsen and Nelson stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committees, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will beallowed for oral presentation.

WRITTEN TESTIMONY

Senators Bentsen and Nelson stated that the Committees would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by June 1, 1977, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington D.C. 10510.

[S. 285, 95th Cong., 1st sess.]

A BILL To protect private pension plan participants from excessive concentration of the investment of tax-exempt private pension assets in a small number of corporate stocks by amending the Internal Revenue Code of 1954 to impose reasonable investment limitations on large pension managers

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Tax-Exempt Private Pension Investment Act of 1977".

SEC. 2. EXCISE TAX ON LARGE PENSION MANAGERS FOR INVESTMENTS IN EXCESS OF THE LIMITATIONS ON STOCKHOLDINGS.

(a) IN GENERAL.—Chapter 43 of the Internal Revenue Code of 1954 (relating to qualified pension, etc., plans) is amended by adding at the end thereof the following new section:

SEC. 4976. EXCISE TAX ON LARGE PENSION MANAGERS FOR INVESTMENTS IN EXCESS OF THE LIMITATION ON STOCKHOLDINGS.

"(a) INITIAL TAX.—There is imposed on each pension manager with investment authority for pension assets with a fair market value of more than $1,000,000,000 a tax of 5 percent of the amount of each investment made by him during his taxable year in violation of the provisions of subsection (c).

"(b) ADDITIONAL TAX.—If a pension manager who is liable for the payment of a tax under subsection (a) for any taxable year fails to correct the violation of subsection (c) which resulted in that liability within the correction period, there is imposed on that pension manager a tax of 100 percent of the amount of that investment to the extent that, on the last date of that correction period, that investment is still in violation of the provisions of subsection (c).

"(c) LIMITATION ON STOCKHOLDINGS OF PENSION MANAGERS.—No pension manager with investment authority for pension assets with a fair market value of more than $1,000,000,000 shall invest any of the pension assets over which he has discretionary investment authority in the securities of any corporation with a capital account of more than $150,000,000 if as a result of such investment the pension manager holds more than 5 percent of any class of security of any corporation with respect to his aggregate discretionary pension assets.

"(d) DIVESTITURE NOT REQUIRED IN CERTAIN CASES.—It is not a violation of the limitation contained in subsection (c) for a pension manager to retain a security held by a trust managed by him which he may not acquire for the trust under subsection (c) if the acquisition of that security occurred prior to the effective date of this section.

"(e) DEFINITION.—For purposes of this section—

"(1) PENSION MANAGER.—The term 'pension manager' means any person who is authorized to invest the assets (or any part thereof) of a pension plan or who invests assets which are held to provide any retirement benefits. All pension managers under common control shall be aggregated for the purposes of applying this section. A pension manager shall not include a person who manages a profit-sharing or employee stockownership plan if such plan has assets in excess of $1,000,000,000.

"(2) DISCRETIONARY INVESTMENT AUTHORITY.—The term 'discretionary investment authority' means the power to invest pension plan assets (or any part thereof) or any assets which are held to provide any retirement benefits without prior approval of any other person.

"(3) SECURITY.—The term 'security' means any share of common stock in any corporation, any security other than a common stock which is convertible into common stock, any other class of stock in any corporation whose owners are entitled regularly to vote, and any other security determined by the Secretary to constitute a security for purposes of this section.

"(4) CORRECTION PERIOD.—The term 'correction period' means the 180-day period beginning on the date on which an investment is made by a pension manager in violation of the provisions of subsection (c).

"(f) RULES FOR CAPITAL ACCOUNT.—For purposes of this section, the capital account of a corporation is deemed to be less than $150,000,000 if, as reported to the shareholders of the corporation in the annual report reflecting the most recently ended fiscal year of the corporation, or the year in which the stock was first acquired by the pension manager, the paid-in capital and earned surplus of the corporation is less than $150,000,000.

"(g) WAIVER AUTHORITY; REGULATIONS.—The Secretary is authorized to waive the provisions of this section with respect to any proposed investment upon application made by a pension manager who demonstrates to the satisfaction of the Secretary that the requested waiver is not inconsistent with the purposes of this section. The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section.".

(b) The table of sections for such chapter is amended by adding at the end thereof the following item:

"Sec. 4976. Excise tax on large pension managers for investments in excess of the limitation on stockholding."

(c) EFFECTIVE DATE.—The provisions of this section apply to securities acquired after December 31, 1977, but all other securities held as pension assets shall be taken into account in applying such provisions to the acquisition of securities after the date without regard to when such other securities were acquired.

SEC. 3. MODIFICATION OF THE PRUDENT MAN RULE.

(a) GENERAL RULE.—A trust which is part of a pension plan and which meets the applicable requirements of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to pension, profit-sharing, stock bonus plans, etc.) shall not be held to fail to meet the requirements of section 401(a)(2) of such Code, or to fail to meet the requirements or to violate the provisions, of any other Federal or State law restricting or limiting the investment of the assets of such a trust (other than provisions of law prohibiting self-dealing or establishing prohibited transactions for persons investing such assets) on account of any investment of such assets by a fiduciary of the trust in the securities of any corporation with a capital account of less than $25,000,000 or any investment company (including a partnership) not described in section 401(b)(1) which invests primarily in such securities if the market value of such securities, when added to the market value of all other such securities held by that trust, does not exceed 2 percent of the market value of all assets of the trust. The provisions of this subsection shall be applied without regard to any increase in the market value of securities of a corporation with a capital account of less than $25,000,000 which occurs after the securities were acquired by the trust, and without regard to any decrease in the market value of other securities held by the trust which occurs after the securities of that corporation were acquired by the trust.

(b) WAIVER.—For purposes of this section, trust assets invested in the securities of a corporation described in subsection (a) shall be treated as having been invested in a corporation not described in subsection (a) if the pension manager of a trust demonstrates to the satisfaction of the Secretary of the Treasury, under such regulations and procedures as he may prescribe, that the securities of that corporation should be treated as the securities of a corporation not described in this section.

(c) LAWS NOT AFFECTED.—For purposes of this section, the Secretary of the Treasury shall determine and publish by regulation the provisions of law referred to in subsection (a) as "provisions of law prohibiting self-dealing or establishing prohibited transactions for persons investing such assets".

(d) DEFINITION OF SECURITY; CAPITAL ACCOUNT RULE.—For purposes of this section, the therm "security" has the meaning given it in section 4976 of the Internal Revenue Code of 1954; and the term "capital account" means the paid-in capital and earned surplus of the company as reported to the shareholders.

(e) EFFECTIVE DATE.—The provisions of this section apply to securities of a corporation with a capital account of less than $25,000,000 acquired after December 31, 1977, but all other securities held by a trust shall be taken into account in applying such provisions to the acquisition of securities of that corporation after that date without regard to when such other securities were acquired.

SEC. 4. CONFORMING AMENDMENTS TO THE INTERNAL REVENUE CODE.

The Secretary of the Treasury shall, as soon as practicable but in any event not later than 90 days after the date of enactment of this Act, submit to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate, a draft of any technical and conforming changes in the Internal Revenue Code the changes in the substantive provisions of law made by this Act.

[From the Congressional Record, Jan. 1, 1977]

BY MR. BENTSEN

S. 285. A bill to protect private pension plan participants from excessive concentration of the investment of tax-exempt private pension assets in a small number of corporate stocks by amending the Internal Revenue Code of 1954 to impose reasonable investment limitations on large pension managers; to the Committee on Finance.

PENSION INVESTMENT ACT OF 1977

Mr. BENTSEN. Mr. President, I am today introducing tax legislation to insure that large managers of tax-exempt private pension assets diversify their investments to include the stocks of a larger number of corporations in their portfolios. This legislation is needed to protect the retirement benefits of countless American workers and senior citizens. The legislation has been formulated after 4 years of extensive hearings and study by the Senate Finance Committee's Financial Markets Subcommittee, which I chair. As a member of the Senate Finance Committee, I intend to push for early action during the 95th Congress on this important tax legislation. Today there are more than $200 billion of private pension assets and these assets receive as estimated tax subsidy of $4 billion annually.

Mr. President, today private pension assets are managed by a very small number of financial institutions located in a very few localities. There have been instances in which these pension managers tended to concentrate their investments in the stocks of the same few companies. This creates a potentially dangerous investment situation for pension plan participants. If one of this very small group of pension managers decides to sell a major investment, on a bit of news, and other managers attempt to follow, they find that the "gate" suddenly gets very narrow. This situation can result in a very substantial reduction in the price of the stock to the detriment of countless American workers and retirees.

Greater safety of pension assets can be insured if pension investments are reasonably diversified and decisionmaking is spread over a larger number of advisers. This will help avoid tendencies toward a "follow-the-leader" syndrome. It will also help avoid precipitous fluctuations in stock prices and self-fulfilling prophecies.

To demonstrate the extent to which the management of pension assets is concentrated in a small number of financial institutions, let us look at some statistics. Just 15 of the largest bank trust departments manage $140 billion of assets, including $75 billion of private pension assets, and that $75 billion represents about 80 percent of the total pension assets managed by all 4,000 trust departments throughout the country. Similarly, 12 of the largest insurance companies manage over $160 billion in assets, including about $56 billion of private pension assets, or 79 percent of the total pension assets managed by all 1,800 life insurance companies. In addition, several of the largest self-management pension plans have assets in excess of $2 billion. A mere two dozen private financial managers have responsibility for managing over $130 billion of pension assets. Such concentration of financial activity in a small number or large institutions tends to give them a disturbing amount of power over the Nation's economic life.

The potential for large financial managers to exert influence over major portions of our economy can be illustrated by these fact: With respect to discretionary investments, in 1975 Morgan Guaranty Trust Co., the Nation's largest bank trust department, held 9 percent of the outstanding shares of International Paper Co., 9 percent of the outstanding shares of Pepsico, Inc., and 8 percent of Squibb Corp. In fact, other pension managers have held even larger portions of the outsanding stocks of some companies.

Dominant stock market trading by the investment committee of a single pension manager can substantially influence or even virtually set stock market prices. During 1973, 1974, and 1975 there were 16 instances in which Morgan Guaranty Trust Co.'s net purchases or sales of issues on the New York Stock Exchange exceeded 20 percent of the total trading in those stocks during the year. For example, Morgan Guaranty bought 31 percent of all the shares of International Nickel traded in 1975.

To help prevent excessive concentration, my legislation would impose reasonable limitations on the amount of stock that a large pension manager could hold in any one company. Under this legislation a tax penalty would be imposed on any large pension manager that holds more than 5 percent of the outstanding stock of any security with respect to the manager's aggregate discretionary pension assets.

However, the limitation would not apply retroactively. Managers of pension accounts would not be forced to dispose of current stock holdings. In addition, these diversification requirements would apply only to those large pension managers with over $1 billion of pension assets. These financial institutions are the ones that have the potential to exert enormous influence over our economy.

A number of our Nation's largest bank trust departments recognize the wisdom of such limits, and in fact, have already adopted very similar limits on a voluntary basis. The purpose of putting these limits into law is simply to insure that all pension managers follow the example that some of the best have established on their own.

Decades ago, Congress enacted tax incentives to encourage the growth of pension plans. Under current tax laws, qualified private pension plans receive three tax benefits. First, employers are given a tax deduction for all contributions made to a qualified plan. Second, the investment earnings of assets in the plan are tax exempt. Third, employer contributions are not taxable to the employee at the time of contribution. Rather, the income is deferred until the money is actually distributed to the employee after his retirement—at which time he is usually in a much lower tax bracket.

Tax-exempt private pension plans today receive an estimated tax subsidy of $4 billion annually. Inasmuch as the Federal Government encourages the creation of pension plans through our tax laws, these tax laws must include safeguards to prevent excessive concentration of pension investments.

There is substantial precedent under both State and Federal law for limitations on the amount of stock that a pension manager can hold in one company. Insurance companies are so limited in practically every State. Mutual funds are subject to holding limits established by Federal law.

There are five major reasons for imposing diversification requirements on pension managers:

HELP PROTECT THE SAFETY OF PENSION ASSETS

First, excessive concentration of pension investments in a few select stocks raises disturbing questions about the safety of the enormous amounts of pension money. In testimony before the Senate Financial Markets Subcommittee, one trust department officer argued that those of us who advocate limits on their holdings are ignoring their fiduciary responsibilities for these funds. Quite the contrary. Prior to coming to the Senate, I was involved in the management of an insurance company, a mutual fund and a savings and loan association, as well as several banks—all of which involved fiduciary relationships. It is precisely because of the fiduciary responsibilities that limitations are needed.

The retirement incomes of countless Americans depend directly upon the safety of the pension investments. Excessive concentration of investments in only a few stocks jeopardizes the safety of these assets since a major decline in value of only two or three of these select stocks would substantially reduce the value of the pension assets.

HELP PREVENT CONCENTRATION OF ECONOMIC CONTROL

Second, limitations on the investments of pension managers will help prevent a smaller number of large institutions from achieving too much control over our entire economy.

We must never allow our financial institutions to control American business to the extent that such institutions control Germany or Japanese businesses, for example.

The Senate Financial Markets Subcommittee has obtained data indicating that pension managers often hold large portions of the outstanding shares of a single company. In 1973, one bank trust department held more than 14 percent of the outstanding shares of Walt Disney, almost 12 percent of Schlumberger, and over 10 percent of Polaroid. The aggregate discretionary accounts of another large bank included more than 17 percent of one company, close to 17 percent of a second company, and over 10 percent of a third.

A follow-up study by the Senate Financial Markets Subcommittee in 1975 revealed that with respect to discretionary investments Morgan Guaranty Trust

Company held 9 percent of the outstanding shares of International Paper Company, 9 percent of the outstanding shares of Pepsico and 8 percent of Squibb Corp. U.S. Trust Co. held almost 10 percent of the shares of WUI, Inc., and almost 9 percent of Hudson Pulp & Paper. Mellon Bank held 10 percent of the outstanding shares of Nalco Chemical and 8 percent of Mellon National Corp. Continental Bank held 33 percent of Northwestern Steel and Wire and 25 percent of Victor Comptometer Corp.

Continued institutional acquisition of large portions of American corporations will lead to too few individuals possessing too much economic control over the entire economy. Limitations on institutional holdings will help prevent this.

HELP PROMOTE GREATER LIQUIDITY IN OUR STOCK MARKETS

Third, holding limitations would help provide greater liquidity in the stock market. Thousands of individual investment decisions, occurring hour after hour, are necessary to allow our capital markets to price securities in a manner which reflect their true value and to provide the liquidity that has made our capital markets unique in the world. One of the factors that detracts from liquidity of the markets is the holding by a few institutions of a large amount of the stocks of a limited number of companies.

Relative stock prices play an important role in the allocation of capital in our economy. Valuations—reflected in stock prices—govern the allocation of resources that produce the millions of different products and services turned out by the American economy. Whether a company is able to issue new stock or obtain additional debt to finance a new expansion frequently depends upon what its stock is selling for. It is essential to the health of the country that its stock be accurately priced.

Limits on the stock that one pension manager can hold in one company will limit the money this manager can pour into the market to bolster the price of any particular stocks. This will limit the ability to create self-fulfilling prophecies. The ability of pension managers to channel billions of dollars of new pension money every year into a few select stocks can have a very distorting effect on our stock market and our economy.

The problem of stock market liquidity was comprehensively analyzed in a 1976 study by one of the Nation's foremost authorities on institutional investors, Prof. Roy Schotland of Georgetown University Law School. According to his study, Morgan Guaranty's trust and investment divisions brought 38.5 percent of all the shares of Kaiser Aluminum & Chemical in 1975. Morgan Guaranty Trust Co. has raised no question about his figures. In that same year, Morgan also accounted for net purchases of Potlach amounting to 31.4 percent of total trading, 30.8 percent of International Nickel, 28.6 percent of Crown Zellerbach, and 24.1 percent of Manufacturer's Hanover. During 1973, 1974, and 1975 there were 128 instances where Morgan's net purchases or net sales of New York Stock Exchange stocks exceeded 5 percent of the total purchases or sales in those stocks. In 16 of those instances, Morgan accounted for more than 20 percent of the buying and selling.

In his study, Professor Schotland commented that—

"It is impossible to measure how much price impact such trading does have, because so many factors go into each stock's price at any moment. But it defies belief that massive buying or massive selling would not have significant impact, at least in the shortrun . . . Even if one were not concerned by a pattern of heavy trading on behalf of the Morgan alone, this is the ripest time for guarding against the spread of such dominant or unduly influential trading. We should not allow any single committee of investment managers in any single institution to dominate major segments of our equity markets. Such domination threatens the soundness of market pricing."

Arguing that limiting the amount of trading any investor could do was impractical, Professor Schotland concluded that the solution to the problem lies in limiting the amount of any one stock an institution could hold. He said a holding limit would not only encourage diversification of the stock market investments of large trust departments but would also spread assets among a greater number of banks and other investment managers as new pension accounts avoid trust departments already near their limit in some stocks. Professor Schotland said:

"The resulting increase in diversification of holdings within the huge trust departments, and in dispersion of trust assets among a larger number of trust departments and other investment managers will go far toward reducing any one (or a few) institutional investor's domination of trading."

Of course, even with holding limits there will still be instances of very large trading by a single institutional investor. However, the limits will greatly reduce the magnitude of such instances and the frequency of occurrence.

ENCOURAGE DISPERSION OF PENSION ASSETS AMONG A LARGER NUMBER OF MANAGERS

Fourth, these limits will encourage the spreading of pension assets among a larger number of managers. This is bound to occur as new pension accounts avoid the handful of large trust departments which will already be at the limit of their holdings in some securities so that a new account could not be invested in any of those stocks. For the same reason, even some existing pension accounts are likely to reduce their additions to funds managed by the largest institutions.

ENCOURAGE INSTITUTIONAL INTEREST IN WELL-MANAGED AND MEDIUM SIZED COMPANIES

Fifth, these limitations on concentration will encourage greater institutional interest in the many other well-managed companies that now have seriously limited access to our Nation's capital markets. Diversification of pension investments into these companies will substantially increase competition in our economy at the same time as it provides greater safety for the funds. In particular, these limitations will promote greater investment in many smaller and medium-sized companies that have strong historical earnings records and good growth prospects.

Americans too often forget the indispensable role of small business in promoting healthy competition in our economy, creating jobs for a growing work force and developing innovative ideas and products. It is the small businessman who provides jobs for about one-half of our private work force.

Traditionally, it has been relatively easy for an American to go into business for himself, to become his own boss. This has been good not only for the millions of individual Americans who have set up their own businesses, but also for our economy at large. This great diversity of ownership has spurred competition, helping keep prices down, helping assure a wide variety of goods and services and helping bring strength and resilience to our free enterprise system.

In recent years it has become particularly difficult for small businesses to raise the capital needed to expand or modernize or simply get off the ground. We may never know how many potential "Xeroxes" or "Polaroids" have failed to get started over the past few years for a lack of startup capital. The initiative of smaller investors and smaller enterprises led to the development of the photocopying industry, of insulin, of cello-phane, or air-conditioning, the cyclotron, and many other products and processes too numerous to list. We cannot afford to stifle this progress.

Mr. President, for these reasons prompt enactment of my proposed holding limitations is needed.

Under my legislation, a tax penalty would be imposed on any large pension manager whose investments violated the diversification standards. These limits would apply only to financial institutions that manage $1 billion or more of pension assets.

If any large manager of tax-exempt funds exceeded these limitations—for example, by purchasing an additional 1 percent of the outstanding shares of a company in which it already holds 5 percent—a penalty tax equal to 5 percent of the excess holdings would be imposed on the manager by the Internal Revenue Service. Then, if the manager failed to dispose of the excess holdings within 180 days. IRS would impose an additional penalty of 100 percent of the excess.

Furthermore, these limitations would not apply to investments in companies with a capital account of less than $150 million. To limit investments in small and medium size companies would discourage institutional investors from looking for opportunities among smaller companies. The institutional investor wants a position large enough to have a real effect upon the portfolio. In addition, the cost of analyzing a company relative to the potential dollar investment must be recognized. By excluding smaller companies from these restrictions, institutions would be encouraged to take the time to analyze the smaller companies.

Before drafting this legislation, I sent detailed questionnaires to the Nation's largest bank trust departments. Their replies enabled me to select the most reasonable percentage limits for holdings.

Many of the Nation's leading banks have indicated that a bank should hold no more than 5 percent of a company's outstanding shares. Several years ago the executive vice president of the First National City Bank, stated:

"If we held more than 5 percent of a company's stock, we'd be concerned that we could become locked in. That 5-percent limit is our working rule for good market liquidity."

Another bank said that as a general rule, it does not want its aggregate discretionary holdings to represent more than 5 percent of a company's outstanding shares.

Some argue that holding limits cannot be applied to the aggregate holdings of pension managers since some institutional investors do not deal with a common pool of funds but instead deal with many different individual accounts which must be treated separately. However, one must remember that instituitonal investors presently must make allocations between the various accounts they hold. As examples, large banks must allocate purchases of the shares of small and new companies among various accounts. In addition, bank trusts must allocate promising new issues among their various accounts. Several banks have indicated that they have one investment committee which makes the final decision as to what stocks to buy and sell. Clearly, such a system requires an allocation of the purchases and sales among accounts with the same investment goals. There is no reason why pension managers cannot adopt an allocation policy to comply with aggregate holding limitations since they now must have an allocation policy anyway.

MODIFICATION OF THE PRUDENT MAN RULE

The second major provision in my bill would prevent the "prudent man" rule which currently applies to all pension managers from artificially discouraging pension investments in new and expanding smaller companies. These are companies in great need of equity capital which present a higher than normal risk but offer the possibility of a higher than normal return.

A great deal of the recent growth of institutional investments has been due to the inflow of private pension funds. The assets in private pension funds currently exceed $200 billion and the figure is rising annually, with much of the increase being invested in common stocks.

The 1974 Pension Reform Act (ERISA—Employee Retirement In come Security Act) includes a Federal "prudent man" rule which exposes the managers and trustees of pension plans to liability for losses resulting from unreasonable investments. Certainly, this is necessary to protect pension assets against highly risky investments but it has also had a very undesirable and unintended side effect. It has led to even greater concentration of investments in companies which have been thoroughly analyzed and stamped with the approval of giant bank trust departments. Trustees are more reluctant to reach out beyond successful, solid, well-researched companies toward those which are newer and attractive but less completely tried. Yet we must not forget that at one time IBM, Xerox, and Polaroid were new and untried companies.

My legislation would provide pension managers with leeway to invest 2 percent of the assests of any pension plan in companies with paid-in capital of less than $25 million or in venture capital funds which invest in such companies. This would be a modification of any Federal or State prudent many rule for just 2 percent of the pension assets. However, the "leeway clause" would not relieve a fiduciary from any existing prohibition against self-dealing or fraudulent transactions. It would relieve a fiduciary from liability only with respect to the riskiness of an investment. Nor would the "leeway clause" imply that investments in all companies of less than $25 million are high risk investments. Many are not. This provision would simply allow a limited amount of pension assets to be invested in a small company which presents a higher than normal risk but offers a potentially higher than normal return. The leeway clause would be a purely voluntary provision for pension plans.

It is essential that Congress define the prudent man investment standard in such a way that it does not actively discourage investments by pension funds in smaller companies. The unintended effect of the prudent man rule has been to artificially confine the investment of pension fund assets to blue-chip securiites. Since pension funds are a major source of equity capital the result has been to deprive many smaller and medium-sized companies of the investment capital they need to prosper and grow.

Sixty-four percent of pension trustees surveyed by the International Foundation of Employee Benefit Plans in 1976 reported that as a result of the 1974 pension law they were less willing to invest in anything other than blue-chip-type investments.

In response to a questionnaire, the executive vice president of Chemical Bank told the Senate Financial Markets Subcommittee:

"A number of factors, including the enactment of ERISA, have caused us to reduced substantially our investment of pension funds in venture capital situations."

An executive of the Wachovia Bank & Trust Co. stated:

"Because of ERISA, we feel it is no longer appropriate to make venture capital investments in a retirement fund. While our investments in this area had been minimal prior to enactment of ERISA, we now believe that no investments of this type are appropriate."

In earlier years, pension plans provided a large portion of the funds that were invested in venture capital. Other venture capital investors have been foundations, private individuals, casualty insurance companies, and bank holding companies. However, investment by these groups has been reduced because of these groups has been reduced because of depletion of their capital. Pension funds today are the only major source of capital accretion, other than large corporations, that could fund a significant number of developing companies.

In the 1960–69 time period, a number of pension plan investment managers made direct investments in private equities of developing companies. After 1969 there was a substantial shift by pension managers to the recognition that effective venture investing requires specially skilled support and involvement in the activities of the developing company. As a result a large portion of pension plan investment in developing companies in the 1970–74 time period was through the medium of venture capital funds.

Since passage of ERISA there has been little investment by pension plans in venture capital funds even though during the 5 years preceding ERISA at least 50 venture funds had been established with a substantial part of their funding provided by pension plans.

A 2-percent leeway clause to the prudent man rule would be analagous to the so-called basket clauses found in a great many State insurance laws. Many States permit life insurance companies to invest a portion or their assets in companies which otherwise would not qualify as acceptable investments. A leeway clause for pension funds would be modification of any State or Federal prudent man rule.

A leeway clause for 2 percent of the assets of a pension trust would certainly not jeopardize the safety of the pension assets. The leeway clause applies only to 2 percent of the assets of a pension trust and investments in some unseasoned companies can be very profitable.

Artificial legislative restrictions on investments in smaller startup companies can severely impede economic growth. Economic growth in our Nation depends upon the availability of a sufficient supply of venture capital for the risk-takers and entrepreneurs who have the initiative to start new businesses and to develop imaginative new ideas.

Let us look at some examples of the importance of venture capital to our entire economy.

Venture capital was essential in the creation of transistors. It is the transistor which made possible the large central computer industry and the military instrumentation industry. The development of the minicomputer industry depended in the availability of venture capital. The minicomputer industry not only provides substantial jobs and tax revenues but has also been a major factor in improving the productivity of industry. Everyone is familiar with pocket calculators. Pocket calculators are solely the product of American technology and venture capital.

A venture capital enterprise funded by risk investments developed the know-how for miniaturized semiconductors called MOS's. With this know-how and technology an entire new industry was created and America still leads the world in the field. The total initial risk capital investment was relatively small, especially when compared to recent total industry sales.

Indeed, venture capital has had an important impact on any number of high-growth industries—semiconductors, minicomputers, all kinds of other computer-related products, hand-held calculators, automatic editing typewriters, CATV, hi-fis, new medical instruments and a wide variety of others.

Even frozen orange juice was developed through venture capital. A great many jobs have been brought back to the United States from Japan through the development of the small chips that are used in hand-held calculators, and this type of advance is now being applied to electronic watches. These were developments by small companies that were not subject to the restrictions of a large company environment and could attract the bright young scientist, production manager and marketing people to move the product into the marketplace. And it is also the result of venture capitalists who were willing to risk their capital to build new companies to better serve the public.

We cannot maintain a healthy, competitive and growing economy unless there is enough capital available for the risk-takers and entrepreneurs who want to develop their ideas into business. That capital—venture capital—is in very short supply these days and artificial legislative restraints on how it is invested must be removed. It has been estimated that my proposed 2-percent leeway clause to the prudent man rule could free up hundreds of millions of dollars for investment in smaller companies without jeopardizing the integrity of pension funds.

In conclusion, limits on the stock market investments of tax exempt pension assets are needed to protect private pension plan participants from excessive concentration of pension investments and to encourage greater institutional interest in a larger number of corporate stocks. These limits would help prevent a small number of large pension managers from achieving too much control over our economy. In addition, these limits would encourage the dispersion of pension assets among a larger number of managers. A 2-percent leeway clause to the prudent man rule would prevent this rule from artificially discouraging pension investments in new and expanding small companies that are in great need of equity capital.

Mr. President, at this point I ask unanimous consent to have printed in the Record, a factsheet describing the bill I am introducing today, as well as an editorial from Pensions and Investments magazine endorsing my proposed revision of the prudent man rule.

[There being no objection, the material was ordered to be printed in the Record as follows:]

FACTSHEET—SENATOR LLOYD BENTSEN'S PROPOSED "PENSION INVESTMENT ACT OF 1977"

Reasonable limitations on the stock market investments of tax exempt private pension assets are needed to protect private pension plan participants from excessive concentration of pension investments. Today private pension assets are managed by a very small number of financial institutions located in a very few localities. There have been instances in which these pension managers tended to concentrate their investments in the stocks of the same few companies. This creates a potentially dangerous investment situation for pension plan participants. If one of this very small group of pension managers decides to sell a major investment, on a bit of news, other managers attempt to follow, they find that the "gate" suddenly gets very narrow. This situation can result in a very substantial reduction in the price of the stock to the detriment of countless American workers and retirees.

Greater safety of pension assets can be insured if pension investments are reasonably diversified and decision-making is spread over a larger number of advisers. This will help avoid tendencies toward a "follow-the-leader" syndrome. It will also help avoid precipitous fluctuations in stock prices and self-fulfilling prophecies.

If one pension manager holds an unduly large proportion of the stock of a company, that manager's decision to sell could virtually set the market price of the stock. For example, the Morgan Guaranty Trust Company (New York), which held 12 percent of Schlumberger's stock in 1973, sold about one out of every eight Schlumberger shares traded in 1974 and 1975. While holding 11 percent of the outstanding shares of Philip Morris, the Morgan Guaranty Trust Company sold one out of ten, and *also* bought one out of 20 Phillip Morris shares, traded in 1974, then in 1975 sold one out of every 8 Phillip Morris shares traded.

Tax exempt private pension plans today receive an estimated tax subsidy of $4 billion annually. Inasmuch as the Federal Government encourages the creation of pension plans through our tax laws, these laws must include safeguards to protect American workers and retirees.

The stockholding limitations of the "Pension Investment Act" would apply to approximately 20 of the Nation's largest bank trust departments, 12 of the Nation's largest insurance companies and several large self-managed pension plans. These financial institutions are the ones that have the potential power to exert an enormous impact on the entire economy.

1. Limitation on the stock holdings of large pension managers.—A tax penalty would be imposed on any pension manager with over $1 billion of pension assets that holds more than 5 percent of the outstanding stock of any security with respect to the manager's aggregate discretionary pension assets.

The limitation would not apply retroactively. Managers of pension accounts would not be forced to dispose of current stock holdings.

If any manager of tax exempt pension funds exceeded the limitation (for example, by purchasing an additional one percent of the outstanding shares of a company in which it already holds five percent), a penalty tax equal to five percent of the excess holdings would be imposed on the manager by the Internal Revenue Service. In the event that the manager fails to dispose of the excess holdings within 180-days, IRS would impose an additional penalty of 100 percent of the excess on the manager.

These limitations would not apply to investments in companies with a capitalization of less than $150 million.

2. Modification of the prudent man rule.—Pension managers would be given leeway to invest 2 percent of the assets of any pension plan in companies with a paid-in capital of less than $25 million or to invest in venture capital funds which invest in such companies. This would be a modification of any Federal or State "prudent man rule" for two percent of the pension assets. However, the leeway clause would not relieve fiduciaries from any existing prohibition against self-dealing or fradulent transactions. Nor would the "leeway clause" imply that investments in all companies of less than $25 million are high-risk investment. Many are not.

This provision would prevent the "prudent man rule" from continuing to artifically discourage pension investment in new and expanding smaller companies. Economic growth in our Nation depends upon the availability of a sufficient supply of venture capital for the risk takers and entrepeneurs who have the initiative to start new businesses and to develop imaginative new ideas. Yet 64 percent of the pension trustees surveyed by the International Foundtation of Employee Benefit Plans in 1976 reported that as a result of the 1974 pension reform act they were less willing to invest in anything other than blue-chip type investments. The purpose of this leeway clause is simply to correct an unintended side effect of the 1974 pension reform act.

[From Pensions & Investments Magazine, Nov. 22, 1976]

Prudent Man Revision Could Create More Jobs

President-elect Jimmy Carter and most of his Democratic colleagues in Congress expressed great concern during the election campaign about the high level of unemployment in the United States.

Congress has tried to tackle the problem by passing bills designed to put the unemployed on the public payroll, but this is obviously an expensive, inefficient, short-term expedient.

A far better approach is to encourage the creation of jobs in the private sector. Many of those espousing this approach speak in terms of tax incentives to business to create new jobs for the hard-core unemployed.

But while giving money directly to the poor is acceptable, Congress usually balks at giving money to business to create meaningful jobs, so the tax incentive idea seems unlikely to get very far. That's a shame.

The Committee of Publicly Owned Companies (COPOC) has come up with a program which will help create jobs without costing the government, and hence the taxpayers, a cent.

COPOC wants Congress to define the "prudent man" investment standard in such a way that it does not actively discourage investment by pension funds in smaller companies. It is campaigning to have this definition made when Congress takes up revision of ERISA in 1977.

The committee argues that an unintentional effect of the ERISA investment standard has been to largely confine the investment of pension fund assets to blue chip securities.

Since these funds are a major source of equity capital, the committee argues, the result has been to deprive thousands of small and medium-sized companies of the investment capital they need to grow, prosper, produce goods and services and create jobs.

It says institutional investors have been "intimidated" by the prudent man standard, as stated in ERISA, or are taking refuge behind it, and increasingly limiting their investments to blue chip and fixed-income securities.

It points out that during the two years following the passage of ERISA, only 471 new issues of common stock were marketed compared with 888 new common stock issues in the two preceding years.

Further, 64 percent of pension trustees surveyed by the International Foundation of Employe Benefit Plans reported that as a result of ERISA they were less willing to invest in anything other than blue-chip type investments.

The committee has proposed that the stated objectives of ERISA should be amended to expressly declare a policy allowing pension funds to invest in a broad spectrum of American companies, and that the prudent man standard should be interpreted in that light.

It has also proposed that the prudent man rule be clarified to be expressly applicable to the total portfolio of pension plan investments rather than each individual investment.

And it has endorsed the Bentsen bill which proposes that pension fund managers should have leeway to invest up to 1 percent of the assets of any pension plan in companies with paid-in capital of less than $25 million.

These seem to be eminently sensible proposals. Pension funds should be invested in a broad spectrum of companies. Indeed, ERISA specifies diversification. Unfortunately, that has been offset by fear of fiduciary liability so that only 50 or 100 major stocks are favored.

The COPOC is not alone in calling for a wider, more modern interpretation of the prudent man rule in terms of the whole portfolio. James Hutchinson, former administrator of the Pension and Welfare Benefit Programs at the Labor Department, recently lent his voice to the call.

The Bentsen bill also seems to be a responsible proposal which may do some good without jeopardizing the integrity of pension funds. It could free up as much as $850 million for investment in smaller companies.

These modest and sensible proposals deserve consideration by the new administration and Congress, and active support by the pension industry.

FACTSHEET—S. 285: SENATOR LLOYD BENTSEN'S PROPOSED "PENSION INVESTMENT ACT OF 1977"

Reasonable limitations on the stock market investments of tax exempt private pension assets are needed to protect pension plan participants from excessive concentration of pension investments. Today private pension assets are managed by a very small number of financial institutions located in a very few localities. There have been instances in which these pension managers tended to concentrate their investments in the stocks of the same few companies. This creates a potentially dangerous investment situation for pension plan participants. If one of this very small group of pension managers decides to sell a major investment, on a bit of news, and other managers attempt to follow, they find that the "gate" suddenly gets very narrow. This situation can result in a very substantial reduction in the price of the stock to the detriment of countless American workers and retirees.

Greater safety of pension assets can be insured if pension investments are reasonably diversified and decision-making is spread over a larger number of advisers. This will help avoid tendencies toward a "follow-the-leader" syndrome. It will also help avoid precipitous fluctuations in stock prices and self-fulfilling prophecies.

If one pension manager holds an unduly large proportion of the stock of a company that manager's decision to sell could virtually set the market price of the stock. For example, the Morgan Guaranty Trust Company (New York), which held 12 percent of Schlumberger's stock in 1973, sold about one out of every eight Schlumberger shares traded in 1974 and 1975. While holding 11 percent of the outstanding shares of Phillip Morris, the Morgan Guaranty Trust Company sold one out of ten, and *also* bought one out of 20 Phillip Morris shares, traded in 1974, then in 1975 sold one out of every eight Phillip Morris shares traded.

Tax exempt private pension plans today receive an estimated tax subsidy of $4 billion annually. Inasmuch as the Federal Government encourages the creation of pension plans through our tax laws, these tax laws much include safeguards to protect American workers and retirees.

The stock holding limitations of the "Pension Investment Act" would apply to approximately 20 of the Nation's largest bank trust departments, 12 of the Nation's largest insurance companies and several large self-managed pension plans. These financial institutions are the ones that have the potential power to exert an enormous impact on the entire economy.

1. LIMITATION ON THE STOCK HOLDINGS OF LARGE PENSION MANAGERS

A tax penalty would be imposed on any pension manager with over $1 billion of pension assets that holds more than 5 percent of the outstanding stock of any security with respect to the manager's aggregate discretionary pension assets.

The limitation would not apply retroactively. Managers of pension accounts would not be forced to dispose of current stock holdings.

If any manager of tax exempt pension funds exceeded the limitation (for example, by purchasing an additional one percent of the outstanding shares of a company in which it already holds five percent), a penalty tax equal to five percent of the excess holdings would be imposed on the manager by the Internal Revenue Service. In the event that the manager fails to dispose of the excess holdings within 180-days, IRS would impose an additional penalty of 100 percent of the excess on the manager.

These limitations would not apply to investments in companies with a capitalization of less than $150 million.

2. MODIFICATION OF THE PRUDENT MAN RULE

Pension managers would be given leeway to invest 2 percent of the assets of any pension plan in companies with a paid-in capital of less than $25 million or to invest in venture capital funds which invest in such companies. This would be a modification of any Federal or State "prudent man rule" for two percent of the pension assets. However, the leeway clause would not relieve fiduciaries from any existing prohibition against self-dealing or fraudulent transactions. Nor would the "leeway clause" imply that investments in all companies of less than $25 million are high-risk investments. Many are not.

This provision would prevent the "prudent man rule" from continuing to artificially discourage pension investment in new and expanding smaller companies. Economic growth in our Nation depends upon the availability of a sufficient supply of venture capital for the risk takers and entrepeneurs who have the initiative to start new businesses and to develop imaginative new ideas. Yet 64 percent of the pension trustees surveyed by the International Foundation of Employee Benefit Plans in 1976 reported that as a result of the 1974 pension reform act they were less willing to invest in anything other than blue-chip type investments. The purpose of this leeway clause is simply to correct an unintended side effect of the 1974 pension reform act.

[S. 901, 95th Cong., 1st sess.]

A BILL To make it easier to comply with certain Federal employee benefit plan requirements by amending the Internal Revenue Code of 1954 and the Employee Retirement Income Security Act of 1974 to eliminate dual Treasury and Labor Department jurisdiction over certain requirements, to reduce the number of reports and other paperwork required thereunder, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Pension Simplification Act".

SEC. 2. TERMINATION OF LABOR DEPARTMENT'S JURISDICTION OVER PARTICIPATION, VESTING, AND FUNDING.

(a) PARTICIPATION, VESTING, AND FUNDING.—Subtitle B of title I of the Employee Rertiment Income Security Act of 1974 is amended by striking out part 2 (relating to participation and vesting) and part 3 (relating to funding).

(b) YEAR OF SERVICE REGULATIONS.—Section 410 (a)(3) of the Internal Revenue Code of 1954 (relating to definition of year of service) is amended by striking out "of Labor" wherever it appears.

(c) CLERICAL AMENDMENT.—The table of contents of such Act is amended by striking out the items relating to part 2 and part 3.

SEC. 3. TERMINATION OF TREASURY DEPARTMENT'S JURISDICTION OVER PROHIBITED TRANSACTIONS.

(a) IN GENERAL.—Chapter 43 of the Internal Revenue Code of 1954 (relating to qualified pension, etc., plans) is amended by striking out section 4975.

(b) CLERICAL AMENDMENT.—The table of sections for such chapter is amended by striking out the item relating to section 4975.

SEC. 4. AUTHORITY TO REQUIRE REPORTS.

(a) IN GENERAL.—Section 103 of the Employee Retirement Income Security Act of 1974 (relating to annual reports) is amended to read as follows:

"REPORTS

"SEC. 103. The Secretary may require employee benefit plans to which this part applies to file such reports as he determines are necessary to carry out the policy declared in section 2 of this Act. The Secretary may require such plans to furnish or make available for inspection copies or summaries of reports and other information required under this section to participants and beneficiaries.".

(b) REPEAL OF CERTAIN SPECIFIC REPORTING REQUIREMENTS.—Section 104(a)(1) of such Act (relating to filing with Secretary and furnishing information to participants) is amended—

(1) by inserting "and" after the semicolon in subparagraph (A);

(2) striking out the semicolon in subparagraph (B) and inserting in lieu thereof a period;

(3) by striking out subparagraphs (C) and (D); and

(4) by striking out ", summary plan descriptions," in the second sentence.

(c) CLERICAL AMENDMENT.—The table of contents of such Act is amended by striking out the item relating to section 103 and inserting in lieu thereof the following:

"Sec. 103. Reports.".

SEC. 5. CIVIL ENFORCEMENT ACTIONS BY TREASURY DEPARTMENT.

Section 3002 of the Employee Retirement Income Security Act of 1974 (relating to procedures with respect to continued compliance with requirements relating to participation, vesting, and funding standards) is amended to read as follows:

"(e) The Secretary of the Treasury may bring a civil action to enforce compliance by a plan or a trust with the requirements of part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954. Such an action is in addition to any procedures available to the Secretary under such Code for such purpose.".

SEC. 6. NOTIFICATION OF JUSTICE AND LABOR DEPARTMENTS BY TREASURY DEPARTMENT OF PROHIBITED TRANSACTION VIOLATIONS; SINGLE ANNUAL REPORT FOR BOTH DEPARTMENTS.

Section 3004 of the Employee Retirement Income Security Act of1974 (relating to coordination between the Department of the Treasury and the Department of Labor) is amended by adding at the end thereof the following new subsections:

"(c) Whenever the Secretary of the Treasury knows or has reason to believe that a violation of section 406 of this Act has occurred, he shall notify the Attorney General and the Secretary of Labor.

"(d) Within 60 days after the date of enactment of the Pension Simplification Act, the Secretary of the Treasury and the Secretary of Labor, acting jointly, shall prescribe a single form and a single annual filing date for employee benefit plans (as defined in paragraph (3) of section 3 of this Act) which will satisfy the requirements of both section 103 of this Act and sections 6057 and 6058 of the Internal Revenue Code of 1954.".

SEC. 7. DECLARATORY JUDGEMENTS.

Section 2201 of title 28, United States Code (relating to creation of declaratory judgement remedy) is amended—

(1) by inserting "(a)" immediately before the first word of text of such section, and

(2) by adding at the end of such section the following new subsection:

"(b) For purposes of this section a failure by the Secretary of Labor, the Secretary of the Treasury, or the Pension Benefit Guaranty Corporation to issue or deny a determination or ruling or to take any other action with respect to an employee benefit plan (as defined in paragraph (3) of section 3 of the Employee Retirement Income Security Act of 1974) within 180 days after such determination, ruling, or other action is requested—

"(1) shall be considered to constitute an actual controvery, and

"(2) shall not be considered to be a controversy with respect to Federal taxes

if it involves an issue arising under the Employee Retirement Income Security Act of 1974 of part I of subchapter D of chapter 1, or under chapter 43, of the Internal Revenue Code of 1954.".

SEC. 8. TECHNICAL AND CONFORMING AMENDMENTS.

(a) AMENDMENT OF EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.—

(1) Section 3 of the Employee Retirement Income Security Act of 1974 is amended by striking out paragraphs (22), (25), (28), (30), and (31).

(2) Subsection (i) of section 502 of such Act is amended to read as follows:

"(i) (1) In the case of a transaction prohibited by section 406 by a party in interest with respect to a plan to which this part applies, the Secretary may assess an initial civil penalty against such party of not more than 5 percent of the amount involved. If the transaction is not corrected (in such manner as the Secretary may prescribe by regulation) within 90 days after notice from the Secretary (or such longer period as the Secretary may permit), the Secretary may assess an addtional civil penalty of not more than 100 percent of the amount involved.

"(2) For purposes of this subsection, the term 'amount involved' means, with respect to a prohibited transaction, the greater of—

"(A) the amount of money and the fair market value of the other property given, or

"(B) the amount of money and the fair market value of the other property received,

except that, in the case of service described in section 408 (b)(2) or (c)(2), the amount involved shall be only the excess compensation.

"(3) The fair market value—

"(A) for the purpose of assessing the initial civil penalty, shall be determined as of the date on which the prohibited transaction occurs, and

"(B) for the purpose of assessing the additional penalty, shall be the highest fair market value during the period granted by the Secretary for correction of the transaction.".

(3) Section 2003 and 3003 of such Act are repealed, section 3004 of such Act is redesignated as section 3003, and the table of contents of such Act is amended—

(A) by striking out the items relating to sections 2003 and 3003, and

(B) by striking out "Sec. 3004." in the item relating to section 3004 and inserting in lieu thereof "Sec. 3003.".

(4) Section 3002(a)(4) of such Act is amended by striking out "section 4975(e)(7)" and inserting in lieu thereof "section 414(m)".

(5) Section 4042(d)(3) of such Act is amended by striking out "and under section 4975(e) of the Internal Revenue Code of 1954", and by striking out "and of such section 4975".

(b) AMENDMENT OF THE INTERNAL REVENUE CODE OF 1954.—

(1) Section 401(a)(13) of the Internal Revenue Code of 1954 is amended by striking out the third sentence and inserting in lieu thereof the following: "For purposes of this paragraph a loan made to a participant or beneficiary shall not be treated as an assignment or alienation if such loan is secured by the participant's accrued nonforfeitable benefit and is exempt, under section 408(b)(1) of the Employee Retirement Income Security Act of 1974, from the prohibitions imposed by section 406 of that Act.".

(2) Section 408(e)(2)(A) of such Code is amended by striking out "section 4975" and inserting in lieu thereof "section 406 of the Employee Retirement Income Security Act of 1974".

(3) Section 414(k) of such Code is amended—

(A) by inserting "and" at the end of paragraph (1),

(B) by striking out ", and" at the end of paragraph (2) and inserting in lieu thereof a period, and

(C) by striking out paragraph (3).

(4) Section 414 of such Code is amended by adding at the end thereof the following new subsection:

"(m) EMPLOYEE STOCKOWNERSHIP PLAN.—The term 'employee stockownership plan' means a defined contribution plan—

"(1) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and

"(2) which is otherwise defined in regulations prescribed by the Secretary. For purposes of this subsection, the term 'qualifying employer security' means an employer security which is stock or otherwise an equity security, or a bond, debenture, note, or certificate or other evidence of indebtedness which is described in paragraphs (1), (2), and (3) of section 503(e).".

(5) Section 415(c)(6)(B) of such Code is amended—

(A) by striking out "section 4975(e)(7)" each place it apears and inserting in lieu thereof "section 414(m)", and

(B) by striking out "section 4975(e)(8)" in clause (ii) and inserting in lieu thereof "such section".

(6) Section 503(a)(1)(B) of such Code is amended by striking out "referred to in section 4975(g) (2) or (3)" and inserting in lieu thereof the following: "a governmental plan (within the meaning of section 414(d)) or a church plan (within the meaning of section 414(e)) with respect to which the election provided by section 410(d) has not been made."

(7) Section 1504(a) of such Code is amended by striking out "section 4975(e)(8)" and inserting in lieu thereof "section 414(m)".

(8) Section 6213(e) of such Code is amended—

(A) by striking out ", 4975 (relating to excise taxes on prohibited transactions)", and

(B) by striking out "4971(c)(3), or 4975(f)(4)" and inserting in lieu thereof "or 4971(c)(3)".

(9) Section 6503(g) of such Code is amended—

(A) by striking out "or section 4975", and

(B) by striking out "4971(c)(3), or 4975(f)(4)" and inserting in lieu thereof "4971(c)(3)".

(10) Section 7422(g) of such Code is amended—

(A) by striking out "4971, or 4975" each place it appears and inserting in lieu thereof "or 4971",

(B) by striking out "4975(a) (relating to initial tax on prohibited transactions)," in subsection (a),

(C) by inserting "or" before "section 4971(b)" in subsection (a), and

(D) by striking out "or section 4975(b) (relating to additional tax on prohibited transactions)".

(c) AMENDMENT OF OTHER ACTS.—

(1) Section 273(f)(5)(A) of the Trade Act of 1974 is amended by striking out "section 4975(e)(7)" and inserting in lieu thereof "section 414(m)".

(2) Section 301(d)(2)(C) of the Tax Reduction Act of 1975 is amended by striking out "section 4975(e)(7)" and inserting in lieu thereof "section 414(m)".

SEC. 9. TECHNICAL AND CONFORMING CHANGES.

The Secretary of the Treasury shall, as soon as practicable but in any event not later than 90 days after the date of enactment or this Act, submit to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate a draft of any technical and conforming changes in the Internal Revenue Code of 1954 and the Employee Retirement Income Security Act of 1974 which are necessary to reflect throughout such Code and Act the changes in the substantive provisions of law made by this Act.

SEC. 10. EFFECTIVE DATE.

The amendments made by this Act, other than the amendment made by section 5, take effect 90 days after the date of enactment of this Act.

[From Congressional Record, Mar. 3, 1977]

Mr. BENTSEN. S. 901. A bill to make it easier to comply with certain Federal employee benefit plan requirements by amending the Internal Revenue Code of 1954 and the Employee Retirement Income Security Act of 1974 to eliminate dual Treasury and Labor Department jurisdiction over certain requirements, to reduce the number of reports and other paperwork required thereunder, and for other purposes; to the Committee on Finance and the Commitee on Human Resources, jointly, by unanimous consent.

PENSION SIMPLIFICATION ACT OF 1977

Mr. President, I am today introducing legislation to reduce the excessive paperwork and redtape which has resulted from the 1974 Private Pension Reform Act. That act is formally entitled the Employee Retirement Income Security Act—ERISA. The legislation that I am introducing today was formulated as a result of joint hearings and studies on ERISA which were conducted last year by the Senate Small Business Committee, which is chaired by Senator Nelson, and the Senate Financial Markets Subcommittee, which I chaired.

Those hearings clearly demonstrated that a legislative solution is needed to remedy the closely related problems of overlapping jurisdiction in the administration of ERISA and the excessive paperwork and redtape which has resulted from the 1974 law. These problems have resulted despite the good faith efforts of many outstanding public servants to administer the existing statutory pension rules as fairly as possible.

Unreasonably burdensome and costly reporting requirements, particularly for smaller private pension plans, will be counterproductive and may result in the cancellation of many good plans. A reasonable balance must be maintained between the necessity of protecting all pension plan participants from abuses and the necessity of avoiding a situation where many good retirement plans terminate simply because they are being buried in an avalanche of paperwork and redtape. Duplicate reporting requirements impose an unnecessary time and cost burden on businessmen, labor organizations and other administrators of pension plans.

The legislation I am introducing today has three major parts—

First, it will help eliminate dual jurisdiction in the administration of the pension law by giving the Internal Revenue Service exclusive jurisdiction over vesting, funding and participation standards and by giving the Labor Department exclusive jurisdiction over fiduciary responsibility and prohibited transaction standards. The Pension Benefit Guarantee Corporation (PBGC), which is within the Labor Department, would continue to administer the termination insurance program.

Second, the statutory reporting requirements under ERISA will be simplified and reduced. Generally, pension plans will only have to file the one Federal form annually on one filing date. Duplicate and repetitious forms will be eliminated.

Third, a procedure will be established to insure that the Internal Revenue Service and the Labor Department make a timely determination of all requests by pension plans or participants for rulings, exemptions or variances. This will help eliminate the delays and backlogs now prevalent at the Labor Department and IRS.

Mr. President, my proposal should in no way alter the existing point jurisdiction and oversight of pension legislation by the Committee on Finance and the Committee on Human Resources of the Senate. Since private pensions have traditionally been regulated under both Federal labor and tax laws, these two committees of the Senate have worked jointly on this issue in the past and will continue to do so in the future.

There are several compelling reasons for prompt enactment of this legislation.

Repetitive reporting requirements and duplicate regulations may actually be resulting in the termination of some good retirement plans. The purpose of ERISA was to protect private retirement benefits, not to strangle sound plans.

There have been excessive delays in the promulgation of regulations and rulings. Some of my constituents have literally been waiting years for administrative rulings under ERISA. This is not an example of a government which is responsive to the needs of its people.

Dual administration frequently results in some unacceptable, although unintentional, regulatory requirements. For example, pension plans are required by law to notify the pension plan participants and beneficiaries of certain changes in the plan. In order to comply with duplicate rules and regulations, one plan found it necessary to send three separate notification letters to participates—one letter to participants in order to comply with the rules of the Internal Revenue Service, a second letter, with virtually identical information, to comply with the rules of the Labor Department and still a third letter to comply with the rules of the Pension Benefit Guarantee Corporation—PBGC.

Mr. President, although legislation is needed to simplifiy ERISA, Congress must resist efforts to weaken the existing substantive standards which are essential to protect the retirement benefits of the American worker. These minimum standards—vesting, funding, participation, termination insurance, fiduciary responsibility and prohibited transactions—were selected after almost a decade of comprehensive congressional hearings and investigations, conduced primarily by the distinguished chairman of the Senate Labor Committee, Senator Williams, and the distinguished ranking minority member, Senator Javits. These standards represent a fair balance between the need to protect workers from abuses and the need to expand our private retirement system.

Nobody can doubt that effective pension legislation is needed to prevent the countless tragic abuses that have occurred in the past. Take, for example the case of a Wichita Falls, Texas woman who retired several years ago at the age of 65 after 17 years of service with the same employer. She was earning a pension during those years and she confidently approached retirement age expecting to receive her hard earned pension benefits upon retirement. However, due to a technicality in this women's pension plan she lost her entire pension—every single cent of it. Because she had missed 2 years service due to family illness during her employment, this worker lost her entire pension. Economic tragedies such as this are now prevented by ERISA.

I would now like to explain the specific provisions of my simplification bill.

HELP ELIMINATE OVERLAPPING JURISDICTION IN THE ADMINISTRATION OF ERISA

My legislation would help eliminate the serious problem of overlapping jurisdiction in the administration of ERISA. Under existing law, both the Labor Department and Internal Revenue Service jointly implement most provisions of ERISA. The situation has resulted in repetitious reporting requirements and excessive delays in the issuance of rules and regulations. There is simply no justification for two Federal agencies to administer the same portions of the pension law. Dual jurisdiction has prevented efficient administration and enforcement of ERISA. This chaotic regulatory structure has been detrimental to everyone concerned—workers, beneficiaries, businessmen, officials, and pension administrators as well as the Federal officials responsible for administering the law. Public confidence in our private retirement system simply cannot be maintained unless this dual and overlapping jurisdiction is reformed.

As examples, the Internal Revenue Service and the Department of Labor have received nearly 600 requests for exemptions from prohibited transaction provisions of ERISA, yet after 29 months only 12 final exemptions have been issued. It took the two agencies 26 months just to agree to a procedure whereby applicants for exemptions would be considered in a coordinated fashion. More than 2 years after the enactment of ERISA, regulations dealing with the so-called "summary plan descriptions" had not even been issued.

Duplicate reporting requirements impose an unnecessary time and cost burden on businessmen, union and other pension plan administrators throughout the Nation.

Two identical teams of pension experts have been assembled at both the Labor and Treasury Departments at extra cost to the American taxpayer.

To remedy these problems, my legislation would carefully divide pension jurisdiction between the Labor Department and the Internal Revenue Service so as to minimize the existing overlap. Under my proposal, the Internal Revenue Service would be given exclusive jurisdiction over the areas of vesting, funding and participation while the Labor Department would be given exclusive jurisdiction over the areas of fiduciary responsibility and prohibited transactions. The Pension Benefit Guarantee Corporation which is within the Labor Department would continue to implement the termination insurance program.

Today, most of the vesting, funding and participation requirements under ERISA are already administered by IRS and thus the Internal Revenue Service is clearly the most appropriate agency to have exclusive jurisdiction over these particular standards. Similarly, because the Labor Department has been the primary enforcement agency for prohibited transactions and fiduciary responsibility under ERISA, the Labor Department should have exclusive jurisdiction over that portion of the law. The Labor Department has already filed suit or is the intervening party in eight court cases alleging violations of the fiduciary responsibility or prohibited transaction sections of ERISA.

Under my proposal, if the Internal Revenue Service, during the course of a tax audit, learns of the existence of a prohibited transaction, this information would be required to be referred to the Labor Department and the Justice Department for appropriate action.

In addition, under my proposal the Internal Revenue Service would be given flexible enforcement powers such as excise tax pawers and general equitable remedies to enable IRS to enforce the vesting, funding and participation standards in such a way as to best protect the rights of pension plan participants and beneficiaries.

In addition, pension plan participants would be able to appeal all decisions of the IRS as well as the Labor Department in Federal court under this legislation.

Traditionally, under our tax laws, qualified pension plans received three substantial tax benefits. First, employers are given a tax deduction for all contributions made to a qualified plan. Second, the investment earnings of assets in the plan are tax exempt. Third, employer contributions are not taxable to the employee at the time of contribution. Rather the income tax is deferred until the money is actually distributed to the employee after his retirement—at which time he is normally in a much lower tax bracket. The tax subsidy for private retirement plans is estimated to amount to $4 billion annually.

Congress has always recognized that these tax privileges might be abused and accordingly, imposed various reqiurements for favorable tax treatment in an effort to safeguard the rights of lower paid employees. For example, even prior to the enactment of ERISA, section 401(a) of the Internal Revenue Code stated that to qualify for tax privileges a plan established by an employer would have to be for the "exclusive benefit of his employees or their beneficiaries" and must not "discriminate in favor of employees who are officers, shareholders . . . or highly compensated employees." In addition, prior to ERISA, the Internal Revenue Service imposed some limited vesting and funding standards which pension and profit-sharing plans had to comply with in order to qualify for favorable tax treatment.

Furthermore, our tax laws impose limitations on allowable contributions and deductions to private retirement plans. These limitations insure that excessive pension contributions are not used to shelter all of taxable income of any business. These limitations are needed to protect the Federal tax base and insure that adequate tax revenues are collected. The Internal Revenue Service is the only agency which has been given the responsibility to police our revenue raising system.

It is clear that the amount of tax-deductible pension contributions is inextricably tied to the funding requirements under ERISA and the general revenue raising functions of the Internal Revenue Service.

Under ERISA the Internal Revenue Service has had responsibility for administering almost all aspects of the law but particularly the vesting, funding and participation standards. Under ERISA, the Labor Department has been the primary enforcement agency for the provisions dealing with fiduciary responsibility and prohibited transactions. Under my proposal, these agencies would simply be given exclusive jurisdiction over the areas in which they have acquired experience and expertise.

Three additional statutory changes in reporting are essential.

First, as recommended by the staff of the Commission on Federal Paperwork, section 104(a)(1)(C) of ERISA would be amended to eliminate the requirement that a 5-year summary plan description be filed with the Department of Labor. A November 1976 staff report of the Paperwork Commission stated—

"Employers must provide a summary plan description to each employee every five years. ERISA section 104(a)(1)(C) requires the administrator of a plan to file with the Secretary of Labor a copy of the summary plan description at the same time that it is furnished to participants and beneficiaries.

"The purpose of this provision of the statute was to permit the DOL to review and compare the summaries with the complete plan descriptions to assure their completeness, accuracy, understandability, etc. Such reviews are costly, duplicative, and practically impossible to perform, considering time and budget constraints.

"Because DOL receives a copy of the complete plan description and any amendments thereto, it is totally duplicative to forward copies of the five year summary plan descriptions to the agency. Discussions with DOL personnel indicate that they do not use such filings, and that the costs of storage could be avoided.

"It is estimated that the DOL storage costs of more than $1,000,000 every five years may be saved for the government and that the savings to business would be approximately $7,200,000."

Second, as recommended by the staff of the Commission on Federal Paperwork, section 104(a)(1)(D) would be amended to permit notices of amendments to be filed in connection with the annual report rather than as a separate report which currently is required within 60 days of a plan change.

The November 1976 staff report of the Commission of Federal Paperwork stated—

"In view of the fact that employees are notified of changes in their plans, that an annual report containing the same information also must be filed with DOL and IRS, and that there is no specific use for the data in the amended EBS-1 it is believed that a notice of amendment filed with the annual report should replace filing of an EBS-1 sixty days after each amendment. This would not change the requirement to notify participants of plan changes nor would it have any effect on the employer's decision to seek a determination of tax status from the IRS. The estimated savings to business would be approximately $12,000,000."

Third, the long "laundry list" of specific information which must be included in annual reports of pension plans pursuant to section 103 of ERISA would be repealed. Section 103 of ERISA is a six-page detailed list of reporting requirements, some of which are not necessary for full plans. Instead, the Secretaries of Labor and Treasury would be given discretion to require only such information as is needed to protect the rights of pension plan participants and beneficiaries.

These reporting changes will substantially reduce the paperwork burden under ERISA.

HELP ELIMINATE ADMINISTRATIVE BACKLOGS AND DELAY

My legislation would also help eliminate the long delays that now face pension plans in obtaining administrative decisions and rulings. Under my proposal, plans would be able to seek a declaratory judgment in Federal Court if, within 180 days after a request for any tax qualification, variance or other exemption from ERISA, the appropriate agency has failed to make a determination. The provision would simply expand the existing declaratory judgment procedure in section 1041 of ERISA.

Mr. President, I believe my proposals to streamline the administration of ERISA and reduce paperwork will strengthen our private retirement system which is so important to tens of millions of American workers and senior citizens.

IMPORTANCE OF MAINTAINING THE EXISTING SUBSTANTIVE STANDARDS IN ERISA IN ORDER TO PROTECT TEN OF MILLIONS OF SENIOR CITIZENS AND AMERICAN WORKERS

Mr. President, although it is essential to reduce paperwork under ERISA and streamline administration of the law, Congress must resist efforts to weaken the minimum standards of the law which are needed to protect the rights of pension plan participants and beneficiaries. I would like to take a few moments to briefly review the major provisions of ERISA and explain the reasons for enacting them.

One of the fundamental pension problems prior to ERISA involved the loss of pensions by workers who left their jobs after long periods of employement but before their earned pensions became vested because of unreasonable vesting requirements. Vesting occurs when an employee receives a nonforfeitable right to the money contributed to a pension plan on his behalf. Vesting may occur after an employee works for a company a specified number of years or after an employee reaches a certain age and number of years of service. Different pension plans contain different vesting formulas but once an employee's pension rights are vested, the employee is entitled to receive the benefits at the normal retirement age even if he leaves the company before that time. Wherever an employee goes, he retains an absolute right to any vested benefits he may have earned.

Unfortunately, the system did not always work. There were too many examples in which employees, with many years of service with a company, had been denied absolutely all of their earned pension benefits because they separated from their jobs just prior to fulfilling unreasonably stringent vesting requirements. They were left without a retirement income which they had confidently anticipated receiving, and on which they were dependent for decent survival.

For example, consider the case of Stephen Duane who worked at a New Jersey warehouse for 32 years during which time he was accumulating a pension. The warehouse was closed down in 1970 and Stephen Duane lost his job. He was 51 years old at the time, just 4 years short of his company's minimum pension age. As a result he lost all of his pension rights. Despite 32 years of service, during which time he was earning a pension, Stephen Duane received absolutely nothing.

The experience of Thomas Litchko, a father of five, is equally tragic. Mr. Litchko had been employed by the same Pennsylvania corporation for 20 years, during which time he was earning a pension. In the spring of 1972—when Mr. Litchko was 39 years old—his company closed down and he was informed that he had no vested rights, that he was not entitled to any pension whatsoever. Under the provisions of his pension plan, an employee had to reach the age of 40 before he would receive any vested rights. Thomas Litchko was only 1 year short of vesting and consequently lost 20 years' worth of accumulated pensions.

Another example of unreasonable vesting requirements involved the participants of a union-administered pension plan in Chicago. Each local within this union administered its own pension plan. Under terms of these plans a worker had to remain within the same local for 20 years in order to acquire any vested rights. Sometimes a slight shift in jobs—perhaps from the loading docks to the weighing station—involved a shift in union locals and a complete loss of all pension rights for an employee with less than 20 years on the first job.

These are only a few examples of the way countless numbers of American workers had been tragically victimized by unreasonable vesting provisions in their pension plans.

Such tragic loss of pension benefits are now prevented by ERISA. Under ERISA, the employer or union running the plan has the option of meeting one of three minimum vesting formulas. Under one formula, a worker would become 100-percent vested after 10 years of service. Under a second graded formula, a worker would become 25-percent vested after 5 years and vesting would increase by 5 percent a year for the next 5 years and by 10 percent a year for the following 5 years to provide full vesting after 15 years. The third alternative guarantees the worker 50 percent vesting whenever his age and service total 45 years or he has worked a minimum of 10 years and in either case, he is to reach 100 percent vesting after another 5 years.

Furthermore, under ERISA the worker must be allowed to join the plan at age 25, or after a year of service, whichever is later. If he enters at age 25, he can get up to 3 years of back credit toward vesting for years worked in the firm prior to age 25.

These formulas would have guaranteed the pension benefits of Stephen Duane and Thomas Litchko and countless other American workers.

However, a minimum vesting standard by itself most certainly would not provide a complete solution to the problems we witnessed in the private retirement system. Prior to the enactment of ERISA, there had been many tragic examples in which employees had been denied pension benefits—benefits that had actually vested—simply because the pension plan's assets were insufficient to meet all of its obligations.

This posed two related but very important problems—funding and termination insurance.

There is a clear need for minimum funding standards so that pension plans are accumulating sufficient assets to meet their obligations. It is also essential for all pension plans to acquire termination insurance to guarantee payment of vested benefits in the event that a plan happens to terminate with insufficient assets to meet its obligations. ERISA sets minimum funding standards and establishes a termination insurance program.

There were countless examples of pension plan failures that demonstrated this need. A classic example involved the closing of the Studebaker plant in South Bend, Ind., in 1964 and the accompanying termination of its pension plan. Even though this was a liberal plan which called for the systematic funding of liabilities, there were not enough assets available to pay all claims when the plan terminated. After the assets were distributed, 4,000 vested employees between the ages of 40 and 60 had received only 15 percent of their anticipated benefits. In fact, some 2,900 employees under the age of 40, some of whom were vested were left with absolutely nothing.

Unfortunately, this was far from an isolated example.

Government statistics indicate that during 1972 alone more than 15,000 pension plan participants lost retirement benefits because their pension plans terminated with insufficient assets to meet all plan obligations. These amounted to more than $40 million in anticipated retirement incomes. Several thousand of these victims of pension plan terminations actualy lost their entire earned pension, every single cent of it. For these individuals, the collapse of their retirement plan resulted in the loss of 100 percent of their hard earned pension.

As a result, ERISA established minimum funding standards so that all employes will make sufficient contributions to back up all vested benefits over a reasonable period of time. In addition, ERISA established a program of pension, insurance—modeled after the Federal Deposit Insurance Corporation for banks—which will insure that all employees will be protected in the event that their plan does terminate before becoming fully funded.

The assets in private pension plans exceed more than $200 billion. It is essential that those who handle these vast sums of money discharge their duties in the interests of the plan participants and their beneficiaries. Workers' pension funds deserve strong fiduciary protection to insure that their interests are not subordinated to the self-enriching intrigues of "insiders" to the plan.

ERISA established judicially enforceable standards to insure honest, faithful, and competent management of pension and welfare plans.

There had been some notable examples of abuse resulting from conflicts of interest in the handling of pension plan assets. These abuses had been brought to the attention of Congress as a result of congressional investigations, Labor Department investigations as well as court litigation.

Let us examine some of these abuses.

For example, in 1960, the pension plan of a large retail store in Washington, D.C. purchased the real estate used for the retail store for $625,000. In 1968 the plan sold the real estate back to the store for $625,000. The plan and its participants did not realize any appreciation in the value of this real estate while held by the plan. Eight months after the store repurchased this real estate from the plan, it sold the property for $2,385,000.

Another example occurred in 1968 when the president of the X company took over the Y publishing company in Philadelphia. He directed that $6 million of Y's pension plan be invested in the Y publishing company even though Y had lost $62 million since 1961. The union sued the president and two other officials of Y, charging they had "misappropriated, fraudulently converted and dissipated" $6 million from the pension funds. The president got the board of directors of Y to pass a resolution saying that the Y plant in Philadelphia would be closed unless the union dropped its suit and allowed the company to withdraw another $4 million from the pension fund. In effect, the president of Y company said: "It will be put up or shut up. What do you want, the suit or jobs?"

A much discussed example of conflicting interests involving a union official and employee benefit plan participants was exposed by the Senate Permanent Subcommittee on Investigations in 1965. This investigation precipitated much of the original congressional interest in the Federal legislation imposing fiduciary standards on pension and welfare funds.

According to the subcommittee's report—

"George Barasch's domination of the two unions and of their employee benefit plans gave him effective control of approximately $15,500,000 that rightfully belonged to the members of the unions. This sum of money was held in the assets of the several corporations he formed and capitalized with the funds of the employee benefit plans and in the assets of the existing trust funds of the unions. He managed to achieve this position of power because in every fund established and maintained by the unions since they were organized, he served irrevocably either as lifetime sole trustee or as a lifetime union cotrustee."

Additionally, with loans from the funds, the union official established a management firm to administer these funds. He also created several foreign corporations, including "research foundations" in foreign countries into which various funds were channeled with total diversions of almost $5 million.

For his efforts, the union official, was well remunerated, including an annual salary of $35,000 from the management firm, $407,000 in life insurance coverage, and total retirement benefits of $54,098 per year for life—the pension benefit alone was valued at $796,925.

Under pressure from the Senate subcommittee and Federal and State agencies, he returned $4.2 million to the employee benefit funds, resigned as trustee of the funds, and subjected these funds to the supervision of the New York State Insurance Department. However, he was never prosecuted for any violations of law since State and Federal officials apparently concluded that no existing laws were violated.

The prohibited transaction sections of ERISA are needed to protect workers from these kinds of fiduciary abuses.

Unless an exemption is granted by the Secretaries of Labor and Treasury, a pension plan administrator is generally prohibited from engaging in the following transaction under ERISA:

The sale, exchange, or leasing of property between the plan and party-in-interest;

The lending of money or extension of credit between the plan and a party-in-interest;

The furnishing of goods, services, or facilities between the plan and a party-in-interest;

The transfer of assets for the benefit of a party-in-interest; or

The deposit or investment of plan assets outside the United States.

Prior to the enactment of ERISA, such transfers or uses of pension assets were permissible if the transaction was made for "adequate consideration." However, the "adequate consideration" requirement offered little protection for pension plan participants or the integrity of plan funds because the Government would have the difficult burden of proving that the fiduciary's determination of adequate consideration was not made in good faith. The better approach is to prohibit all such suspect transactions and avoid inequitable results through a liberal exemption procedure. The administrations of both President Johnson and President Ford supported the prohibited transaction sections that were incorporated in ERISA.

~~Mr. President,~~ the paperwork imposed by the 1974 pension law is just one small portion of the overall Federal paperwork burden confronting all taxpayers.

Government agencies presently churn out billions of sheets of paperwork for the American people each year, probably enough to fill several major league baseball stadiums. Just to print, shuffle, and store all this paper costs government at all levels an estimated $18 billion annually.

And, at the receiving end of the red-tape tangle, it cost the American people, businessman, and worker alike, another $18 billion to fill out the mass of forms —Internal Revenue Forms, wage and price forms, unemployment forms, health forms, accident forms, social security forms, quarterly this and monthly that.

For many small businesses, this added expense proves to the final straw that drives them out of business. And for those giant corporations that can afford accountants and lawyers to deal with all this paperwork—well, they are forced to pass the cost along to the consumer.

In terms of dollars and cents, or frustration and irritation, the endless tangle of paperwork imposed by the government has become unbearable.

There are well over 5,000 forms in use in the Federal Government, excluding all tax and banking forms. There are 10 forms to be filled out each year for every man, woman and child in the United States. The private citizen is very literally inundated with requests for information.

Some have referred to the endless series of forms and documents as "strangulation in triplicate." Others call it "Federal forms pollution."

It is particularly difficult for small firms to absorb the cost of this paperwork. Small businessmen must employ outside accountants and lawyers to fill out complex forms and keep the extra recordkeeping involved. Professional assistance, of course, is expensive. Having few employees, the small firm finds it more difficult to spread the cost. A rise in per unit cost to cover paperwork can result in loss of sales and loss of competitive standing for small enterprises.

Small businesses, especially the mom and pop operations, must fill out numerous reports, as many as 52 tax forms in a single year. This is not an example of a government which is concerned and responsive to the needs of its people. It is not a government which is protecting free enterprises. It is instead of a government that favors only those large concerns that can satisfy repetitious requess for data, statistics and information.

I began, in the Spring of 1973, to move against this slow and steady strangulation by redtape. I introduced legislation which created a Federal Paperwork Commisssion to study the massive paperwork burden and make recommendations to eliminate much of it.

Based upon recommendations of that Paperwork Commission as well as the recommendation of others, I formulated the "ERISA Simplification Act" which will cut paperwork and redtape with respect to this particular law.

I urge the Senate Human Resources and Finance Committee to promptly hold hearings on the important legislation.

Mr. President, I ask unanimous consent that a fact sheet on this bill be printed in the Record.

[There being no objection, the factsheet was ordered to be printed in the Record, as follows:]

FACT SHEET—SENATOR LLOYD BENTSEN'S PROPOSED "PENSION SIMPLIFICATION ACT OF 1977"

1. Help eliminate overlapping jurisdiction in the administration of ERISA.— This legislation would help eliminate the serious problem of overlapping jurisdiction in the administration of the 1974 Pension Reform Act. This Act is formally entitled the Employee Retirement Income Security Act (ERISA). Under existing law, both the Labor Department and Internal Revenue Service jointly implement most provisions of ERISA. This situation has resulted in repetitious reporting requirements and excessive delays in the issuance of rules and regulations. For example, the Internal Revenue Service and the Department of Labor have received nearly 600 requests for exemptions from prohibited transaction provisions of ERISA, yet after 29 months only 12 final exemptions have been issued. It took the two agencies 26 months just to agree to a procedure whereby applications for exemptions would be considered in a coordinated fashion.

To remedy these problems, this legislation would carefully divide pension jurisdiction between the Labor Department and Internal Revenue Service so as to minimize the existing overlap. Under this proposal, the Internal Revenue Service would be given complete and exclusive jurisdiction over the areas of vesting funding and participation while the Labor Department would be given exclusive jurisdiction over the areas of fiduciary responsibility and prohibited transactions. The Pension Benefit Guarantee Corporation which is within the Labor Department would continue to implement the termination insurance program. Today most of the vesting, funding and participation requirements under ERISA are already administered by IRS and thus the Internal Revenue Service is clearly the most appropriate agency to have exclusive jurisdiction over these particular standards. Similarly, because the Labor Department has been the primary enforcement agency for prohibited transactions and fiduciary responsibility under ERISA, the Labor Department should have exclusive jurisdiction over that portion of the law.

Under the proposal if the Internal Revenue Service, during the course of a tax audit, learns of the existence of a prohibited transaction or other fiduciary violation, this information would be required to be referred to the Labor Department and the Justice Department for appropriate action. Under this proposal, the Internal Revenue Service would be given flexible enforcement powers such as exclusive tax powers and general equitable remedies to enable IRS to enforce the vesting, funding and participation standards in such a way as to best protect the rights of pension plan participants and beneficiaries. In addition, pension plan participants would be able to appeal all decisions of the IRS as well as the Labor Department in Federal court under this legislation.

2. *Reduction of paperwork.*—Several changes in the statutory reporting requirements of ERISA are needed to simplify and reduce the paperwork. Accordingly, under this legislation, the Secretary of the Treasury and the Secretary of Labor will be directed to formulate to the maximum extent feasible, a single annual form with a single filing date which would be filed with the Internal Revenue Service every year by pension plans. Different types of forms could be provided for different types of retirement plans. However, pension plans would generally be required to file only one form annually with the Federal Government. A copy of this form would then be made available to the Department of Labor. Separate annual pension forms by the IRS, Labor Department and the Pension Benefit Guarantee Corporation are generally unnecessary and impose an unnecessary cost burden on businesses and unions throughout the Nation.

The long "laundry list" of specific information which must be included in annual reports of pension plans pursuant to Section 103 of ERISA would be repealed by this legislation. Section 103 of ERISA is a six-page detailed list of reporting requirements, some of which are not necessary for all plans. Instead, the Secretaries of Labor and Treasury would be given discretion to require only such information as is needed to protect the rights of pension plan participants and beneficiaries.

3. *Help eliminate administrative backlogs and delays.*—This legislation *would also help* eliminate the long delays that now face pension plans in obtaining administrative decisions and rulings. Under the proposal, plans would be able to seek a declaratory judgment in Federal court if, within 180 days after a request for any tax qualification, variance or other exemption from ERISA, the appropriate agency has failed to make a determination. This provision would simply expand the existing declaratory judgment procedure of Section 1041 of ERISA.

Mr. ROBERT C. BYRD. Mr. President, I ask unanimous consent that the bill introduced by the Senator from Texas (Mr. Bentsen), relative to the Internal Revenue Code and the Employee Retirement Income Security Act of 1974, be jointly referred to the Committees on Finance and Human Resources.

The PRESIDING OFFICER. Without objection, it is so ordered.

Senator BENTSEN. Secretary Woodworth, we are delighted to have you.

Senator Packwood?

Senator PACKWOOD. Mr. Chairman, I cannot stay for the duration of these hearings. I am glad to hear this panel here, especially Mr. Burkhardt.

What you just said in your opening statement illustrates the problem we face. I sent out on April 4, 1977, a letter to Mr. Burkhardt bringing to his attention some details of a problem I have encountered under ERISA. I have yet to even receive an acknowledgement of the letter 5 weeks later, let alone the interminable delay in dealing with the problem itself.

I am going to ask that that letter be placed in the record and ask Mr. Burkhardt to check and see if you plan to respond to it, and when you plan to respond, at least to acknowledge that you received the letter.

I do have one other letter from a company in Oregon called Bohemia, Inc., and I would like that also placed in the record. I think it can speak for itself.

Senator BENTSEN. Without objection, that will be done.

[The following was subsequently supplied for the record:]

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C., April 4, 1977.

FRANCIS BURKHARDT,
Administrator, Labor-Management Services Administration, Department of Labor, Washington, D.C.

DEAR MR. BURKHARDT: With passage of the Employee Retirement Income Security Act of 1974 (ERISA), the Department of Labor and the Internal Revenue Service share responsibilities for the oversight of many of the financial operations and funding standards of private pension plans. You are, I am aware, charged with administering certain provisions of this law within the Department of Labor.

While the purpose of this legislation is to set standards and provide for the protection of participants in employer-financed pension plans, there is provided, under Section 408 of ERISA, a procedure by which exemptions can be made to certain of the standards created by the law. Before any exemption may be granted, of course, both the Labor Department and the IRS must be satisfied that the exemption will not do harm to the coverage of employees under the plan in question.

I have become concerned that requests for exemptions that fall within a certain class, specifically termed the "third party note" group, have been inordinately delayed. Without meaning to judge the merits of any application for exemption, I believe that prompt discharge of this matter would now be in order. I understand that some applications for exemption have been made as long as two years ago and that the future dispo..ion of these requests is still in doubt.

I would appreciate your looking into this problem for me and your assurance that the Department's thorough review can be brought to a swift conclusion. I hope you'll agree that we owe our constituents a restored sense of credibility in doing not just a good or thorough job, but a prompt one as well.

Cordially,

BOB PACKWOOD.

U.S. DEPARTMENT OF LABOR,
OFFICE OF THE ASSISTANT SECRETARY,
Washington, D.C., May 11, 1977.

Hon. BOB PACKWOOD,
U.S. Senate,
Washington, *D.C.*

DEAR SENATOR PACKWOOD: I regret the delay in responding to your letter of April 4. Under the previous Administration the Pension and Welfare Benefits Program was an autonomous unit within the Labor-Management Services Administration, and mail addressed to me with regard to the Employee Retirement Income Security Act was forwarded to the Program Administrator.

As a result of the delay in responding to your letter, and similar difficulties in the past, I am taking action to assure more expeditious handling of our correspondence.

With regard to your inquiry about the status of an exemption application pursuant to requirements of the Employee Retirement Income Security Act, the sale of third party notes to a plan by parties in interest is within the scope of a class exemption currently under consideration in the Office of Regulatory Standards and Exceptions.

An application for exemption relating to an individual transaction will not ordinarily be considered separately if a class exemption which would encompass the individual transaction is under consideration by the Secretary. Accordingly, applications for individual exemptions are not being considered separately from the pending class exemption and, if the pending class exemption is granted, applicants will be notified.

The large number of applications received has resulted in a delay in processing. You can be assured, however, that every effort is being made to resolve pending applications in the shortest possible time.

I hope this information will assist you in responding to any constituents.

Sincerely,

FRANCIS X. BURKHARDT,
Assistant Secretary of Labor.

BOHEMIA INC.,
Eugene, Oreg., March 17, 1977.

Re: Administration of Employee Retirement Income Security Act of 1974 (ERISA).

Hon. ROBERT PACKWOOD,
U.S. Senate, Senate Office Building,
Washington, D.C.

DEAR SENATOR PACKWOOD: Like many, if not most, substantial employers in the United States, this Company has a qualified private retirement program and various welfare benefit plans for its employees. The Company commits a substantial amount of money, management effort and outside consultant expense to these programs. Through this commitment we seek to provide employee incentives that will benefit all concerned, help long-term employees maintain a decent standard of living when they retire, and protect employees from the financial impact of personal misfortune while they are employed. In our opinion, and the apparent opinion of our advisors, these objectives are being materially hampered by federal administration since the passage of ERISA in 1974.

Our consultants tell us that our plans are well within the mainstream of responsible plan design. We recognize, nonetheless, the need for amending our retirement plans at considerable expense primarily to conform to the relatively rigid format of the plan design requirements in ERISA. We regret that the government chose to regulate substance by so strictly regulating form, but we can see that that is one legitimate approach to the problem. We also can see that adherence to appropriate standards of fairness and impartiality are desirable goals and suitable for government regulation. We also strongly endorse the principle of full communication to employees about their benefits so they will neither be ignorant nor misled. Finally, we can see that safeguards should exist to prevent trustees from manipulating retirement trusts for their own interests or for the interests of overreaching employers. We do not believe, however, that ERISA is being administered in a reasonable and practical way to meet these appropriate objectives and minimize possible abuses.

ERISA is a flawed congressional act. It was the subject of substantial compromises and last minute substantive decisions that required relatively hasty drafting. As a result it is often obscure, inconsistent and difficult to interpret and administer. Nevertheless, we feel that the Department of Labor and the Internal Revenue Service have so administered the law as to aggravate rather than minimize the inherent difficulties in many respects. Some of the more important of these are set out in the enclosed outline.

It is indicative of the complexity of this area of the law and regulations that the enclosed outline is as long as it is and still remains essentially superficial. Detailed explanation of the problems and the possible solutions for any one of the areas touched upon in the outline would require extensive exposition. A number of conclusions, however, seem evident:

ERISA is a very imperfect attempt to regulate pension and welfare plans; its imperfections are being aggravated by obscure and detailed regulations, and its burdens are being increased by IRS and Department of Labor interpretations that complicate rather than simplify.

An inordinate amount of the resources potentially available for creating benefits for employees are being siphoned off into administration.

Employers attempting in good faith to comply with the law in designing and administering their plans are being increasingly frustrated by the apparent impossibility of doing so except at very great expense.

Employees are being harassed and frustrated rather than aided by regulations under the law, particularly by requirements for disseminating information that they cannot understand and in which they are not particularly interested.

Under these circumstances it seems imperative that Congress take some steps to accomplish the following:

1. Simplify and streamline the administration of ERISA, reducing conflicts and overlapping jurisdiction with resulting duplication of effort by plan sponsors and administrators.

2. Translate regulations into readable English with maximum emphasis on simplicity and interpretation of obscure provisions of the law rather than parroting the legal requirements and imposing more complex requirements. (This cannot be overemphasized. A relatively small amount spent on simplification of government regulations could save millions of dollars spent by employers in attempting to comply with the law.)

3. Reduce the demand for enormous detail in reports to the government and distribution of information to employees, concentrating on highlights that will be more valuable when freed from related minutia.

There is no doubt that the private pension and welfare industry will survive in spite of the burden of ERISA and the related regulations of the IRS and the Department of Labor. It would be unfortunate, however, if substantial amounts of money that could be going to employees and retirees continued to be diverted into unnecessary administration. It would also be unfortunate if small and medium-sized companies abandoned their retirement and welfare programs or substantially curtailed them leaving compliance only to very large companies with sophisticated computerized systems capable of meeting the government's elaborate report requirements.

Congress can justify having passed ERISA in the interest of stabilizing private pensions and protecting employees and pensioners. It cannot justify remaining inactive when significant deficiencies of the law have been disclosed and poor administration threatens to subvert the primary goals for which the law was enacted, namely, preservation of a strong and useful private pension system to supplement social security and open and fair administration of welfare benefit plans.

Very truly yours,

FREDERICK G. GENT,
Senior Vice President—Finance.

Enclosure.

OUTLINE OF IMPORTANT PROBLEMS OF FEDERAL ADMINISTRATION OF ERISA

1. PLAN DESIGN

There are many ways in which plan design is more cumbersome and plans more difficult to understand and administer than in the past. Many of these cannot be materially reduced by regulations. The following, however, are areas where regulations seem to have aggravated the problems:

Cashout/buyback

The cashout/buyback provisions of ERISA are the subject of regulations so confusing that totally inconsistent interpretations exist within the IRS and there is widespread misunderstanding among employers. Further, the IRS has established rules relating to defined contribution plans that force the employer to withhold payments to partially vested, terminated employees for as long as 18 to 20 months or encumber the plan with complex accounting details. In a defined benefit plan an employee who is cashed out on break in service and returns to work is given two years after reemployment to decide whether to buy back in. Finally, in order to qualify as a cashout in a defined benefit plan, a payment must be delayed for up to 18 to 20 months in many cases and then must be paid within the following 12 months. Both of these requirements are totally irrelevant to the purpose of the statutory provision that is being interpreted.

Joint and survivor annuities

The IRS has timidly declined to exempt defined contribution plans from the burdensome accounting and notice requirements of the joint and survivor provisions of ERISA even though everyone concedes that their application to defined contribution plans is useless to the employee.

Final regulations on joint and survivor annuity elections require that information be given to each employee nine months before the employee's earliest retirement date. This means more record keeping and surveillance and puts out information far too soon to be of value to the employee. The regulations also established lengthy election periods that cannot be waived by an employee who may wish to start benefits sooner. This can be particularly onerous to an employee on early retirement or disability where there may be no opportunity to start the election period in advance of the expected retirement date.

Vesting

ERISA established three standard vesting requirements, at least one of which has to be met for a plan to be qualified. The law permits the IRS to impose more stringent standards in special cases up to 40 percent vesting after four years graduated to 100 percent vesting after 11 years (the 4 and 40 rule). This IRS initially interpreted this statutory background by making 4 and 40 vesting the standard for virtually all plans. Turnover tests were promulgated that were complex and stringent. They could be satisfied by only a small minority of employers; those who could not satisfy the test had to use 4 and 40 vesting. The tests were withdrawn in the face of widespread objections from representatives of employers and pension consultants.

In spite of the withdrawal of the specific turnover tests, plans are still being examined under a perverse interpretation of the statute: namely, that a plan cannot use a statutory vesting schedule unless the employer can demonstrate nondiscrimination. The obvious statutory scheme is that every employer is entitled to use one of the statutory vesting schedules unless there is something inherent in the situation that suggests probable discrimination. Before ERISA the IRS interpreted its general rules of thumb in this way. In other to get past the transition to ERISA, the IRS has allowed existing plans to be approved if they retain their previous vesting schedule or a more liberal vesting schedule. All new plans, however, must present elaborate justifications that were never required before ERISA. Thus, the IRS seems to assume that all existing plans are probably fair but all new plans, even if similarly designed, are probably unfair. Even if plans are approved with statutory vesting schedules, a significant additional burden is placed upon the employer because of the showing required.

Model profit sharing plan and standard provisions

In an attempt to deal with some plan design problems, the IRS has issued a model profit sharing plan that is one of the most badly drafted legal documents that many attorneys and actuaries have ever seen. The IRS has also issued standard paragraphs to use in plans to meet certain specific requirements. In many cases the requirements met are among the simpler ones for which standard provisions are hardly necessary. The standard provisions themselves with a few exceptions are badly designed and difficult to read. ERISA requires that employers communicate with their employees in a manner calculated to be understood by the average person. The federal regulators have repeatedly failed to apply this standard to the things they have written.

2. DISCLOSURE REQUIREMENTS

As stated above ERISA imposes communication requirements between employer and employees with which few employers would argue in principle. In applying these provisions, the IRS and the Department of Labor have repeatedly required the dissemination to employees of material that is burdensome to prepare and in many cases, essentially worthless. The principal areas of communication are the following:

Summary annual report

ERISA requires that a summary of the annual financial report on the plan be given to participants. As in many other cases the law is regrettably specific about the contents of this summary. There seems no realization of the fact that employees are not accountants, that elaborate statements of assets and liabilities, receipts and disbursements will be largely meaningless for them. As a result the employer is required to prepare and disseminate annually large amounts of financial information at great expense with very marginal benefit to employees. A very simple half-page statement of the financial condition of a plan, with a statement that detailed information is available from the plan administrator, would be much more valuable.

The applicable regulations fail to simplify or reduce the burden. Further, they are so unclear that expensive help from outside consultants is necessary for an employer to know what must be disseminated and to whom.

Summary plan description

This was originally to have been distributed within the first four months of 1975. The deadline for distribution has been repeatedly extended, most recently to May 31, 1977 or 90 days after issuance of a favorable determination letter if later. Final regulations on the content of the summary plan descriptions have still not been promulgated although proposed regulations came out in June of 1975. The proposed regulations are as detailed as one would think to be justified. If a delay in issuing final regulations means that more elaborate requirements are contemplated, this is disturbing. If it means that the Department of Labor simply has not gotten around to the formality of making the proposed regulations final, this is even more disturbing.

Most employers wish to communicate a description of their plans to their employees as promptly as possible after the plans are modified. Restatements to comply with ERISA have been required for calendar year plans since January 1, 1976 and in many cases have been completed. If an employer chooses to prepare and distribute a summary plan description to tell the employees about the plan, the employer runs the risk of having to make substantial changes in the summary if the final regulations depart materially from the June 1975 proposals.

When an intermediate May 30, 1976 deadline for summary plan description distribution was abandoned, the Department of Labor required as a condition that an alternative notice be distributed to employees. This notice was lengthy and obscure. Employees were confused by it and in many cases irritated. As a result of this requirement we have already begun the process of teaching employees not to pay any attention to what is distributed to them about their benefits because it will be obscure and useless.

Notice to interested persons

ERISA requires an employer to notify employees when a plan is submitted to the IRS for a determination letter so an employee may make comments or otherwise intervene. (The likelihood of this is very remote in almost all cases as a practical matter, but some kind of notice is required for certain purposes under ERISA.) The IRS has devised a notice that is so elaborate and detailed that it is highly unlikely that it will be read, much less understood, by any employee. The notice is difficult to prepare, requiring the assistance of the employer's professional advisers and resulting in expense to the employer. The employee receives no benefit from the notice that could be better be accomplished by a simple announcement that the plan is being filed with the Internal Revenue Service for qualification review and that interested parties may comment. Because of its complexity, however, the notice serves further to convince employees that communications from an employer with respect to employee benefits should be disregarded.

3. REPORTING

ERISA seems to proceed on the assumption that substantial abuses in the administration of plans can be discovered and remedied by elaborate reporting to the federal government. This seems a very doubtful premise. The volume of material that is accumulated annually from employers and plan administrators of retirement plans must be staggering. It would seem obvious that every effort should be made to simplify and reduce the burden of reporting so as to make the reports more valuable to the government and minimize the burden on the employer. unfortunately, this approach has not been taken.

Plan description (DOL form EBS-1)

This form was first required in the summer of 1975, then had to be refiled in changed form in 1976. It must be amended whenever there is a material change in the plan, including a change in persons designated as fiduciaries under the plan. The information required goes far beyond the minimum required by ERISA (which is substantial). The form was apparently designed to allow the Department of Labor to make statistical studies of retirement plans. It is not designed to be of any value to employees, who have a right to inspect it. It is presumably not designed as an aid to regulation by the Department of Labor since the IRS is primarily responsible for examining the form of plans for compliance with the law and does so on the basis of review of the actual plan documents. Nonetheless, employers are put to the substantial burden of completing these forms, then refiling them after amendment to meet IRS comments on qualification review (which are almost inevitable because of the newness of the law and the regulations.) There is now talk of consolidating EBS-1 with IRS forms 5300, 5301 and 5302, which are filed to apply for determination of qualification. This would be desirable.

Annual report (IRS/DOL forms 5500, 5500-C and 5500-K)

The Department of Labor and the IRS have issued forms 5500, 5500-C and 5500-K, with related schedules, and companion forms 5501 and 5504 for use in particular cases. The Department of Labor and the IRS have not been able to agree upon a common reporting date and some portions of the forms are required by one of the agencies and out by the other. In addition, the completion of the forms requires a substantial amount of work by the employer's independent accountants, consulting actuary, attorney or inside accounting personnel and in some cases by all of them. ERISA requires plans to report substantial transactions (over 3 percent of the plan assets). The applicable regulations have interpreted this so as to create almost unimaginable burdens on large plans with numerous investment managers and thousands of transactions annually.

We cannot believe that these extensive reporting burdens will result in any significant value to anyone. The IRS and the Department of Labor will still have to investigate and take individual action against plans that appear to be abusing the law. When they do, they can demand substantial accountings from those plans that have aroused suspicion. It seems fundamentally in error to impose extremely burdensome financial reporting requirements on all plans as an aid to enforcement of regulations. Among other things it would seem obvious that the government will receive such a mass of information that its very bulk will almost eliminate its usefulness.

Annual registration statement

This statement on IRS Form SSA is useful and, in contrast to other forms published under ERISA, is as simple and condensed as possible. It does not appear to go beyond the specific requirements of the statute in any material respect.

Reportable events

Different provisions of ERISA require that a great variety of events with respect to a plan or its administration be reported to the Department of Labor, the Pension Benefit Guaranty Corporation or the IRS. These include:

Any material changes in the plan description.

Any change in the name of the plan.

Any change in the name or address of the plan administrator.

The merger, consolidation or division of the plan.

Disqualification of the plan.

Any amendment reducing accrued benefits.

Twenty percent or greater reduction in participations in a year or 25 percent or more over two years.

Termination or partial termination for tax purposes that does not constitute a termination for PBGC purposes.

Failure to meet funding standards.

Inability to pay benefits when due.

Distribution to a substantial owner over a specified maximum in a two-year period.

Merger or consolidation.

Any other event that the PBGC determines requires a report.

There are some duplications, and overlapping in the above list because different sections of ERISA require reports under somewhat different language to different agencies. This list ~~of~~ requirements increases the likelihood of employer administrative error, increases the dependency upon outside consultants with resulting expense to the plan and seems a doubtful way to improve the ability of the government to regulate plans effectively.

4. PENSION BENEFIT GUARANTY CORPORATION

Outside of the reporting of events and the complex requirements for merger or consolidation of plans, most of the PBGC jurisdiction relates to plan termination. As a result, PBGC administration has limited pertinence to ongoing administration of plans and does not figure largely in the problems of the employer or plan administrator.

5. WELFARE BENEFIT PLANS

Welfare benefit plans are not affected by most of the design requirements of ERISA so revision of plans has not been required. ERISA requires added documentation to name plan administrators and plan fiduciaries, however, and to create claims procedures. These requirements are of debatable value and are a nuisance to employers. They are insignificant, however, compared to the reporting and disclosure requirements.

For each welfare plan an employer must meet the following reporting and disclosure requirements:

Plan description; annual reports (except insured or unfunded plans with fewer than 100 participants); summary annual report (except insured or unfunded plans with fewer than 100 participants); and summary plan description.

Of these, the only item of any value or interest to employees is the Summary Plan Description. Distribution of plan booklets by employers has been routine for such plans for years; creating a formal legal requirement in itself is not burdensome. Because of the exaggerated specificity of ERISA and the regulations, however, all booklets will require revision. The cost of such revisions will be almost a complete waste.

The more serious problem is with the other reporting and disclosure requirements. These can be extremely burdensome to the employer and provide no discernable value to employees. What employee will read or be aided by a lengthy financial report on a Blue Cross plan? How is anyone benefited by an employer filing an EBS-1 or a 5500 with the government?

An employer with numerous plans with varying contract years must file a multitude of annual reports (and distribute a multitude of summaries) at various times throughout the year. Consolidating the plans into one fiscal year to avoid this is artificial and requires another useless step with commensurate waste. The management and consultant time and expense in this reporting and disclosure are significant; no benefit of any kind to anyone is apparent. We cannot imagine anyone in government using those reports for any purpose other than gathering statistics (a questionable function that in any event could be more easily done other ways). And we know that the impact on employees is negative.

Senator BENTSEN. Mr. Woodworth?

Mr. WOODWORTH. Thank you for those kind remarks.

STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. WOODWORTH. I am pleased to appear before you today to discuss two bills dealing with jurisdiction over employee benefit plan matters and private pension investments.

When employee benefit plan legislation was being considered by Congress several years ago, extensive consideration was given to Government agency jurisdiction over the area. The approach which appears in the Employee Retirement Income Security Act of 1974—ERISA—was ultimately enacted. As you know, various parts of ERISA are administered by three separate agencies, that is, the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation. For the most part, the jurisdiction of PBGC does not overlap that of either of the other two agencies. However, administration under a substantial portion of ERISA is shared by both the Service and the Department of Labor.

For example, there are parallel provisions under the tax and labor law portions of ERISA regarding participation, vesting and funding. Some of these provisions must be implemented by regulations issued by the Treasury Department, while other parts must be implemented by Labor regulations. In each case, the regulations of the respective agency are binding on the other agency.

Perhaps the most troublesome area of dual jurisdiction has come up in connection with prohibited transactions. If anyone wants to engage in a transaction with an employee benefit plan which is otherwise prohibited under ERISA, he must request an exemption from both the Internal Revenue Service and the Labor Department. As a practical matter, an exemption will be fully effective only if it is issued by both agencies. This dual jurisdiction has resulted in long delays in the issuance of exemptions.

The reporting requirements under ERISA have also created serious problems for plan administrators and employers. For example, annual reports must be filed with both the Internal Revenue Service and the Department of Labor. The agencies have developed a single set of forms which can be filed with each agency. Duplicate filings are required at present, although the agencies have agreed upon a procedure for single agency filing.

S. 901 offers a legislative solution to the problem of dual jurisdiction. It would retain jurisdiction in each of the three existing agencies, but eliminate any overlapping responsibility. The Internal Revenue Service would have exclusive jurisdiction over those ERISA provisions dealing with participation, vesting and funding as they relate to retirement plans. The Service would also have responsibility over a number of miscellaneous retirement plan provisions, such as qualified joint and survivor annuities and the assignment and alienation of benefits.

The Department of Labor, on the other hand, would have exclusive jurisdiction over disclosure, fiduciary conduct, and prohibited transactions. Labor Department jurisdiction in its areas of responsibility would extend to all employee benefit plans. This would include both retirement and welfare programs.

Both Treasury and Labor are presently studying the problems which have been created by dual jurisdiction under titles I and II of ERISA. Both Departments are working toward a joint recommendation in this area, which we expect to have later this year.

Based upon our preliminary analysis, however, the Treasury Department believes that dual jurisdiction should be eliminated through a clear assignment of responsibility. Our joint recommendation, however, is likely to differ somewhat from the provisions of S. 901 as to the assignment of responsibility. Accordingly, at this time it is premature to discuss specific assignments of responsibility in detail.

Moreover, we have been advised by the Office of Management and Budget that this problem will be addressed within the framework of the President's Governmentwide reorganization program under OMB leadership. It is likely to take several months to complete that work. In the course of that review, OMB would consider the problems which exist as a result of different rules applied by PBGC and the Service in connection with plan terminations.

The Treasury believes the reorganization review to be undertaken in this area should give strong consideration to allowing each agency to continue to develop its strongest area of competence under ERISA and prior law. The Department of Labor has developed expertise in connection with reporting and disclosure, fiduciary responsibility and prohibited transactions.

The Internal Revenue Service has had a long history of implementing participation, vesting, and funding requirements in the administration of the Internal Revenue Code provisions relating to qualified retirement plans. The Internal Revenue Service also has expertise in administering provisions relating to prohibited transactions for over 25 years.

Another consideration the Treasury believes should be part of the reorganization review is that there may be cases in which the Internal Revenue Service or the Department of Labor has unique ability with regard to one part of a broad area. Therefore, appropriate divisions of responsibility might not be exclusively on the basis of broad classifications.

The administration's position on these and other questions will be presented to the committee after the reorganization study is completed and a policy is established as to the appropriate assignments of responsibility.

S. 901 does raise a number of technical problems that we will be discussing with the Labor Department. For example, both the tax and labor law provisions under ERISA prescribe reporting requirements. As we have mentioned, an annual report must be filed with both the Department of Labor and the Internal Revenue Service.

S. 901 would require the agencies to prescribe a single form and a single annual filing date for these reports. In general, however, we believe that a more orderly set of reporting requirements could be developed if a single annual report had to be filed only with the Internal Revenue Service. This would eliminate the duplication of effort involved in filing the same form with both agencies.

Both agencies and in some instances PBGC have an essential need for information concerning retirement plans. That need could be satisfied if the receiving agency were required to make the annual reports available to other agencies in a manner that will permit them to carry out its statutory responsibilities in a timely fashion.

S. 901 would also give Federal district courts the right to issue declaratory judgments when Labor, the Service or PBGC failed to act with respect to an employee benefit plan in a matter arising under ERISA. The Treasury Department questions this provision of the bill. As a result of ERISA, the Tax Court already has the authority to issue a declaratory judgment relating to the qualification of retirement plans. The addition of declaratory judgment authority in other areas would seriously hinder the administrative process. The wisdom of insulating the administration of the Federal tax laws from judicial intervention has long been recognized. The Declaratory Judgment Act was amended by the Revenue Act of 1935 to preclude this type of intervention. At that time, the Senate Finance Committee indicated that the amendment was necessary to preserve the orderly and prompt determination and collection of Federal taxes, noting that existing procedures before the courts provided an effective remedy for the correction of errors.

Let me turn now to S. 285, which would limit the amount of stock that certain pension managers could acquire in large corporations and, at the same time, allow plans to invest some plan assets in small riskier companies without regard to the "prudent man" rule. We understand the dual purposes of the bill.

On the one hand, it is designed to prevent a pension manager from controlling such a large portion of a corporation's stock that actions by the pension manager have a disproportionate impact on the market for the stock. On the other hand, it is desirable to stimulate venture capital investments for small businesses. We agree with these objectives and are pleased that the committee is moving to study solutions in this area.

S. 285 would impose an excise tax if a pension manager, such as a bank trustee or insurance company, with investment authority over assets of more than $1 billion were to hold more than 5 percent of any class of stock in a corporation with capital of more than $150 million. The excise tax is structured in the same way as the excise tax on prohibited transactions, which would be deleted by S. 901.

In other words, a tax of 5 percent would be imposed on the excess holdings. If the violation were not corrected within the prescribed period of time, the pension manager would be taxed at a rate of 100 percent on the amount involved. This limitation would not apply retroactively, so that holdings in excess of 5 percent prior to the effective date of the bill would not have to be reduced.

As I indicated, we recognize that the "concentration" rule was designed to prevent stock price manipulation by large financial institutions with significant holdings in a particular stock. In principle, the Treasury Department supports this objective. However, to the extent that concentration in the stock market is a problem, and I don't question whether it is, it would appear that the problem should be addressed not simply in the context of pension funds. Also, it would appear that the issue of an institutional investor's domination of trading in a stock may more appropriately be the concern of the Securities and Exchange Commission.

S. 285 would also give investment managers the ability to invest up to 2 percent of the assets of any one pension plan in companies capitalized at less than $25 million without regard to any State or Federal prudent man rule applicable to pension plans. However, fiduciaries would not be relieved from any existing prohibition against self-dealing or fraudulent transactions.

As I also indicated, the "leeway" rule was designed to prevent the prudent man rule from discouraging investments in new and risky small companies. The Treasury Department supports to encourage capital formation. In the case of retirement plans, however, the protection of the plan benefits has always been of overriding concern.

In this context, the prudent man rule has served to protect beneficiaries from imprudent actions by plan administrators. The preemption of the prudent man rule at both the State and Federal levels would eliminate all protection against imprudent investments. The Treasury Department continues to believe that the concept of prudence should govern conduct of employee benefit plan fiduciaries, including the extent to which they invest plan assets in new venture capital formations.

Thank you very much.

Senator BENTSEN. Senator McIntyre?

Senator McINTYRE. Dr. Woodworth, we had some oversight hearings in the Federal Paperwork Commission and I think ERISA could be classified as a modern monster.

As we listen to the story unfold, how this legislation, so well-intentioned and widely supported by the Senate with a vote of 86 to 7, it seems to me that there ought to be some way that we could prevent this from ever happening again.

The paperwork that flowed out of the Department of Labor crushed little guys all over this country trying to figure out what was expected of them, and I think that what really happened there was, once we passed the bill, there was a great rush to get it out. I believe labor only had about 30 days to throw these regulations together.

Actually, my recollection is that the Labor Department was not too well-versed in this field at all. It was IRS who knew most about the pension plan.

So I would like to ask this question of the Labor Department representative. Since enactment of this bill called ERISA, what could you say about the reduction that has been accomplished in the paperwork as a result of this law? What have you been able to accomplish, if anything, in reducing the demands, the forms, the paper that is pushed out on the people of this country?

Senator BENTSEN. Will the spokesman for the Labor Department identify himself?

Mr. BURKHARDT. I am Frank Burkhardt, Assistant Secretary for Labor.

I am not going to apologize for all the problems of past administrations in terms of administration of this law. I do think it is useful, though, in terms of the reporting and disclosure requirements that we did have under that law to take a look at some of the areas that we did change that were changed in the last couple of years. One of them has to do with the unfunded welfare benefit plans and plans funded excessively through insurance contracts covering less than 1,000 participants.

They were made exempt August 15, 1975, from reporting with the exception of furnishing summary descriptions. That whole bloc was exempted at that time.

As I understand your question, what was done in the years——

Senator McINTYRE. You do not have to go into any detail. It may be good for the record if you could tell us—because if you can enumerate the things you have done. I understand this is a continuing effort. At least we on the Paperwork Commission are hopeful that something is going to be accomplished.

I notice there are a couple of recommendations here that are in Senator Bentsen's bill and we find that before the Commission on Federal Paperwork, December 3, 1976, the Employee Retirement Income Security Act. Do you support these recommendations 1 and 2 on page 22? I will read them.

Recommendation No. 1, in ERISA section 104(A)(1)(d) should be amended to require that notices of amendments to pension plans may be filed in connection with the annual report rather than as an additional EBS-1 which is a requirement of 60 days within plan change.

Do you favor that, or do you think you have to write on the 60 days?

You fellows are absolutely crazy about information. You want all of the information you can get and more. You have to stop it.

You are nodding your head. You can accept that?

Mr. BURKHARDT. Those recommendations are under study right now. We expect to have changes in all of those areas, just like changing the summary plan description. We put that back because it was unrealistic. It was ready to go, but unrealistic to assume that anybody could have that by July 15th.

It was one of the things I did there to move that back to some time in September so we can have the plans, procedures and regulations out. We are looking at the whole problem. It is catching up with what was done in the past and trying to take care of those needs for the future.

It requires sort of a synergistic approach to this thing. There is a lot of overlap in terms of whether we want to correct the ills of the past or set the record straight in the future. We are trying to do the best we can in that area. We do have those recommendations under study right now.

Senator MCINTYRE. Another recommendation in Senator Bentsen's bill, a recommendation on page 22 on the Federal Paperwork Commission report, section 104(A)(1)(c) should be amended to eliminate the requirement that a 5-year summary plan description should be filed with the Department of Labor.

Do you know whether or not you favor this or oppose this?

Mr. BURKHARDT. That, too, is under study.

Senator MCINTYRE. It is under study? I hope you are studying it pretty hard. Something has to be done.

I come from a small State. I get my ears boxed and my reputation torn up because we are imposing on the people of this country unreasonable regulations and paper. Every time I get a chance to sound off, I do.

I do not dislike bureaucrats. We have a lot of great people working in the bureaucracy. It is getting to be a joke.

I happen to come from—one of my committees is Armed Services where we have a whole language unto ourselves. I have to prepare a DSOC on the ESOC.

Page 31 of the New York Times today talks about this. That is all right, I can catch up with that. But the people back there in New Hampshire, really.

One thing I wonder, do you need to have an annual report? How about a report every 2 years. Do you have to have an annual report?

We did do something about under 100, did we not?

Mr. BURKHARDT. We made a number of changes. I would be happy to prepare for this committee those changes that have taken place, especially small plans and the rest. As we develop our recommendations to that particular study, how we are going to enforce it, we will supply the committee with that, too.

Senator MCINTYRE. Thank you.

Thank you, Mr. Chairman.

Senator BENTSEN. One of the problems that you run into is that legislation is enacted without enough consideration being given to the paperwork impact on smaller firms.

Senator McIntyre. The culprit is us, the Congress. We are the real culprit.

Senator Bentsen. We are going to do something about it.

Senator McIntyre. You should have a requirement in your report on Johnny Jones and the impact on the smaller people in this country.

Senator Bentsen. The testimony I just heard where OMB wants to wait months to decide on reorganization is of concern to me.

Let me ask you, Dr. Woodworth, what are you talking about in the way of time? We have had a great many plans that have lapsed, for many reasons. Some of them because they did not have what we would think of as equitable funding and vesting and chose to use paperwork and redtape as an excuse to quit. I know there are some of those.

I am also convinced a lot of them threw up their hands at the paperwork and redtape involved.

Mr. Woodworth. I realize what you say is true.

Senator Bentsen. We are soliciting the opinions and judgments from Treasury, Labor, and OMB if they have to get into the act too, so that we can move on this thing.

Mr. Woodworth. Presently I am very much aware of the need for action in this area. I think my colleague from the Department of Labor is also. I think you can depend upon the two of us to do what we can to get it out as quickly as possible.

I have been told that OMB is going to want to study it for awhile. I do not know what I can do except repeat that to you and say that I will try and urge them to make their study as short as possible and make this one of the earliest reorganization plans adopted.

Senator Bentsen. I understand the Secretary of the Treasury had a description of ERISA and what it stood for. That shows his concern over some of this regulatory problem that we run into in the overlapping jurisdictions. We look at who heads OMB and he comes from business. Certainly he has been subjected to the problems of ERISA, the duplication, and delays. I hope we will have his strong support in expediting this.

Mr. Woodworth. I would think that we would.

Senator Bentsen. You referred to the fact that Treasury believes that reorganization should give strong consideration to allowing each agency to develop its area of competence under ERISA and prior law. That is what I have been trying to do in this bill, S. 901. It has been traditionally the field of IRS to handle the areas that I have assigned to it under the vesting and funding and for Labor to look at some of the fiduciary responsibilities. That is what we have done.

I hope you fellows do not nitpick at this thing and that you will give it some broad responsibilities and cut out the duplication.

Mr. Woodworth. I have tried to indicate as best I could the view which tended to parallel your kind of division. Obviously, the others want to review the matter and we may differ in particular areas. Also, I think that we certainly start from a position which is very close to the one that you take, although undoubtedly there are some particular areas that will need to be reviewed specifically.

Senator Bentsen. Do I understand that Labor and Treasury are going to a single form and a single annual filing date? Is that correct?

Mr. WOODWORTH. We are prepared to do that. I am not quite certain if it may take a statutory provision in order for us to do that.

Senator BENTSEN. You support the proposal in my bill?

Mr. WOODWORTH. We would like to have a single form as such. We have a single form, as I understand it, right now, but we would also think an additional simplification could be provided if it could be just a single filing.

Senator BENTSEN. I would be delighted to see that, if you fellows can agree on who gets it, and my understanding is then you would share it with the rest of the agencies so that the people operating the plan could just send one report to one of the agencies.

Mr. WOODWORTH. That is the way that we would like to see it, yes, sir.

Senator BENTSEN. I would be very pleased to see that.

Now, on the question of pension investment. I propose a limitation in S. 285 of 5-percent maximum that one of these very major pension managers can own in the stock of one corporation.

You refer to one of the things that we are trying to prevent is the manipulation of stock, and that is correct. But another very major thing we are trying to do to protect the beneficiary of that pension.

You are getting a situation where people who have pension funds more and more tend to protect themselves—the way I can protect myself is to give it to the very largest bank in the country or one of the biggest ones in the country and no one is going to question the competence of management.

But the trouble with that, you are getting a very major concentration of economic control in a very few financial institutions dealing in billions of dollars and when they decide that they have to have enough trading in the stock so they can move in and out, that necessarily limits them on their big investments to major corporations and you get a few of those very big institutions who go into the same corporations, be it IBM or any of the others, and then you let a Federal judge down in Oklahoma decide that there is a serious antitrust question involved with IBM and they all try to get out of that gate at the same time. That gate gets very narrow and you see a substantial drop in the stock until 3 or 4 days later when that judge decides to clarify his opinion and the price begins to recover. If he had not, if he had held to the opinion as was understood in the beginning, what would have happened to the beneficiary of the pension?

What happened when you have a few of those major pension managers who decided they wanted to invest in the so-called nifty-fifty and they were the big investors in the country, and when that went out of style, what happened to those pension funds? How much were they depleted? How far did the investment value go down? How much did that affect the pension beneficiary in this country? Very substantially.

That is one of the things that I am trying to get at. I see a situation where some of these pension funds have been the major trader in stock for as long as 2 years. Do not tell me that does not have an effect on the price of that stock.

You have a situation where a pension manager can get himself into self-fulfilling prophecies, when he has at his disposal billions of dollars to invest. If he has made himself a bad investment, all he has to do is keep buying it, he will hold up that price and make himself look good until the day he decides to retire.

What you need to have a true market in this country is multiple decisions by investors across the country. That is what I am trying to bring about.

Mr. WOODWORTH. Senator, we do not disagree with the objective that you are after at all. I think really that all we are trying to say—and also, we do not question the problems which you indicate arise.

What we really are suggesting is that this is a matter which (1), goes beyond pension funds as such to other large institutional investors, and (2), that this is really a question of regulating investments across-the-board insofar as size in any particular company.

As such, it seemed to us as if it were more appropriately a matter for a rule with respect to SEC. We are not disagreeing with your objectives. We are not at all sure that just picking it out and having the IRS handle this with respect to pension funds alone is a good solution.

Senator BENTSEN. I am deeply concerned about the pension benefits and I think this is one of the ways to protect them.

Pension funds receive a $4 billion tax subsidy annually and pension funds are the largest source of stock market investments today, and they are a rapidly growing source. You take ERISA with the speedup that we brought about in funding for many pension funds, that means that those assets are going to grow faster than they did in the past. There is a move toward pension funds anyway.

Then you turn around and get some of these pension managers concerned with their responsibilities and you see larger and larger institutions and you see a greater and greater concentration. Let me give an example.

The Morgan Guaranty, which held 12 percent of Schlumberger's stock in 1973, sold about one of every eight of Schlumberger's shares traded in 1974 and 1975. While holding 11 percent of the outstanding shares of Philip Morris, Morgan Guaranty sold 1 out of 10 and bought 1 out of 20 Philip Morris shares in 1974 and in 1975 it sold 1 out of every 8 of every Philip Morris traded. That has to have some influence on the price of that stock.

Mr. WOODWORTH. We really do not question that at all. I was just wondering, was Morgan Guaranty acting only with regard to pension funds, or were they acting with regard to their other fiduciary capacity, too?

In other words, is this not broader than just pension plans? That is really all I am saying. It looks as if it is broader than pension funds and as if it is the type of matter that should be a matter of regulation by SEC.

Senator BENTSEN. I think that the pension funds' growing with the rapidity that they are and the serious need to protect the benefits to the pensioner makes it an appropriate source of legislation of this committee.

Before we drafted this legislation, we sent out detailed questionnaires to the Nation's largest bank trust departments and the replies helped in selecting what we thought would be reasonable percentage limitations for holdings.

Many of the banks indicated that the banks should hold no more than 5 percent of a company's outstanding shares. The executive vice president of the First National City Bank several years ago stated if we held more than 5 percent of a company's stock, we would be concerned that we would become locked in. That 5-percent limit is our working rule for good market liquidity.

Other banks, say as a general rule, they do not want aggregate discretionary holdings to represent more than 5 percent of a company's outstanding shares.

Let me give you an example. Prof. Roy Schotland, of Georgetown University Law School, in some of his studies shows that the Morgan Guaranty Trust bought 38½ percent of all the shares of Kaiser Aluminum & Chemical in 1975—38½ percent.

Morgan Guaranty & Trust Co. has raised no question about these figures. In that same year, Morgan also accounted for net purchases of Potlach amounting to 31.4 percent of total trading, 30.8 percent of International Nickel and 24.1 percent of Manufacturer's Hanover. During 1973, 1974, and 1975, there were 128 instances where Morgan's net purchases or net sales of New York Stock Exchange Stock exceeded 5 percent of the total purchases or sales of these stocks. In 16 of these instances, Morgan accounted for more than 20 percent of the buying and the selling.

Professor Schotland commented: It is impossible to measure how much price impact such trading does have, because so many factors go into each price at any moment. But it defies belief that massive buying or massive selling would not have significant impact, at least in the short run. . . . Even if one were not concerned by a pattern of heavy trading on behalf of the Morgan alone, this is the ripest time for guarding against the spread of such dominant or unduly influential trading. We should not allow any single committee of investment managers in any single institution to dominate major segments of our equity markets. Such domination threatens the soundness of market pricing.

These limitations I am talking about, these are the same kinds of limitations you have on insurance companies today. Most States have those kinds of limitations to try to protect the policyholder, to be sure you have safety.

Mr. WOODWORTH. I am not questioning the desirability of limitations of that type.

Senator BENTSEN. On the 2-percent leeway clause, you also have that with insurance companies. One of the unintended results I think of ERISA was that you are finding that investors and managers of these funds are backing way from investing in venture capital and new enterprises in this country, yet this is one of the major sources, or should be, for venture capital, and it is a growing accumulation of capital.

Let me give you an example: 64 percent of the pension trustees surveyed by the International Foundation of Employee Benefit Plans in 1976 reported that as a result of the 1974 Pension Reform Act they are less willing to invest in anything other than blue chip type investments.

Since the passage of the act, there has been little investment by pension plans in venture capital funds, even though during the 5 years preceding ERISA, at least 50 venture capital funds had been established with a substantial part of their funding provided by the pension plans. There has been a change in attitude since ERISA and a drying up of captial for venture corporations.

Senator Nelson?

Senator NELSON. I am sorry I could not get here at the time when you began your testimony.

I understand that the Department of Labor was asked for their comment on the December 1976 Report of the Commission on Federal Paperwork on the Employee Retirement Income Security Act. Has the Department taken a position respecting ths report and the recommendations in the report?

Mr. BURKHARDT. We are in the process now, as I mentioned before, of studying each of those recommendations and we will probably issue some regulations in some form that will attempt to achieve some of the purposes, but we do not have any specific ones right now.

Senator NELSON. When will the Department have a position on the recommendations?

Mr. SACHER. If I am not mistaken, the Department recently sent a letter to either yourself or one of the officials of the Paperwork Commission explaining that several of those recommendations already had been adopted and several others were being studied and I believe that the Department will be concerning itself with those recommendations, some of which clearly require legislative change in the consideration that we are now engaged in on other legislative matters.

We hope to have a uniform administration position on that in the near future.

Senator NELSON. Dr. Woodworth, I understand Treasury now has a detailed compilation of figures on terminations of pension plans since the adoption of the Pension Reform Act in 1974. Is that correct?

Mr. WOODWORTH. Yes; I think that is correct.

The totals for calendar years 1975 and 1976, the receipts that have been received were 28,843——

Senator NELSON. 28,843 terminations?

Mr. WOODWORTH. Applications for approval for termination.

Senator NELSON. Is that from the enactment of the bill, or just since the beginning of calendar year 1976?

Mr. WOODWORTH. Those are the ones that were received, applications for it. The applications processed and closed by a determination letter was 24,347.

Senator NELSON. How many were approved, of that 24,000?

Mr. WOODWORTH. It is my impression that all of them were.

Senator NELSON. There was not any application that was acted upon of the 24,000?

Mr. WOODWORTH. I am not certain of that, but I believe that is correct. I would like to have the right to correct that if it is wrong, but it is my understanding that we really do not have the right to prevent a termination if that is desired by the applicant.

Senator NELSON. I think IRS has some powers in this area, do you not? I think my impression is that there are some grounds on which you can act.

Mr. WOODWORTH. I do not believe we can prevent a termination. I do believe that we can determine the qualification status for the past which affects deductions and taxation based on whether the plan was permanent or and whether there has been discrimination, so we can make changes in tax liabilities with respect to past periods. I believe it is correct that we really cannot stop a termination, if that is what they desire.

Senator NELSON. Why do the businesses have to bother to make application, then?

Mr. WOODWORTH. To see that the funds are being distributed, the funds that are left, in a manner which entitles them to the tax benefits of qualified plans. It is to protect the tax status with respect to the distributions as such.

Senator NELSON. You also have the statistics for each of those years on the formation of new plans?

Mr. WOODWORTH. Yes; I think that is correct.

All right. In 1975 the number of initial qualifications of plans was 30,043.

Senator NELSON. Was 30,043.

Mr. WOODWORTH. In 1976, it was 29,566. I should make clear that these figures may differ some from others, because this includes both the defined benefit and defined contribution plans.

Senator NELSON. Does your chart show the breakout on that?

Mr. WOODWORTH. It did with respect to the termination. I do not see it with respect to the new plans.

Insofar as terminations are concerned, you recall the 24,000 that I read you before, 24,347 as to the applications processed by the IRS closed by a determination letter. The defined benefits plans represented 13,764 of those, but defined contribution plans represented 10,583.

Senator NELSON. Have you submitted that summary for the record?

Mr. WOODWORTH. I would be glad to prepare one along this line and submit it, yes.

Senator NELSON. How many pages is it?

Mr. WOODWORTH. This is just an accumulation of material that we received from the Internal Revenue Service bearing on this. The statistics that you are referring to consist of applications received from different districts. I do not believe that is of particular concern to you.

On these two points that you raise, we have it by year, 1967 to 1976 as to the new plans adopted in each one of those years and also the other material that I read as to plan terminations, we have that by month through 1975 and 1976.

I will be glad to submit that for the record if you like, that part.

Senator NELSON. Yes; I would appreciate it.

Do you have the formation of pension plans and the terminations for the prior 4 or 5 years?

Mr. WOODWORTH. I do not have them here, but I think we could get that for you, if you like.

Senator NELSON. Yes; and we will put that in the record. We would like to have both.

[The following was subsequently supplied for the record:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., May 20, 1977.

Hon. LLOYD BENTSEN,
Chairman, Private Pension Plan Subcommittee, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you once again for the opportunity to appear on May 10 at the joint hearing before the Private Pension Plans Subcommittee and the Select Committee on Small Business regarding your proposals relating to employee benefit plans, S. 285 and S. 901. As was requested at the hearing, I am submitting for the record the attached information on qualified retirement plan adoptions and terminations for the period from 1967 through 1976.

Attachment I reflects the number of corporate plan terminations in connection with which determinations were requested from the Internal Revenue Service. Attachment II is a further refinement to break those terminations down between pension plans and profit sharing plans. Because of the system employed by the Service at the time, money purchase plans are included in the pension plan category. Attachment III provides an analysis of the number of initial determination requests received by the Service, also broken down between profit sharing plans and pension plans.

The termination of a retirement plan is within the discretion of the employer maintaining the plan, although that discretion may be subject to restrictions imposed by a collective bargaining agreement or for some other reason. The Internal Revenue Service cannot prevent the termination of a plan. The role of the Service in connection with a termination is to determine whether the termination of the plan will cause it to lose its qualification for tax purposes. One of the basic requirements for qualification of a retirement plan is that the plan be a permanent program. It is presumed at the outset that a plan is permanent. Therefore, if the plan meets the other requirements for qualification, the Service will issue a determination letter indicating that it is a qualified plan.

If the plan is terminated within a few years after its adoption, the early terminiation will be an indication that the plan was not permanent. If the Service determines that it was not permanent, the plan will lose its qualification retroactively to the time of its adoption. However, if the plan is terminated within a few years due to business necessity, the permanence rule will have been satisfied, and the plan's qualification can be protected. Although there is no requirement that an application be made to the Service regarding the consequences of a termination, an employer which intends to terminate the plan will frequently request the Service to give an advance determination regarding the effect of the termination on the plan's qualification. The Service is also willing to make such a determination if the plan has already been terminated.

Sincerely yours,

LAURENCE N. WOODWORTH,
Assistant Secretary for Tax Policy.

Attachment.

ATTACHMENT I

NUMBERS OF CORPORATE PLAN TERMINATIONS FOR THE YEARS 1967-76

[Based on applications for determination letters disposed of by issuance of a determination letter]

Calendar year	Plans in existence Jan. 1	Number of corporate plan terminations	Percent of total plans terminated
1967	192,875	1,303	0.7
1968	212,094	1,443	.7
1969	234,433	1,729	.7
1970	260,779	2,306	.9
1971	291,047	3,335	1.1
1972	328,376	3,550	1.1
1973	374,191	4,130	1.1
1974	429,666	4,604	1.1
1975	484,981	8,276	1.7
1976	506,916	16,071	3.2

ATTACHMENT II

HISTORICAL ANALYSIS OF CORPORATE TYPE PLAN TERMINATIONS BY DETERMINATION LETTERS ISSUED

	Pension or annuity plans	Profit-sharing plans	Stock bonus	Total determination letters issued on terminations
1967	602	700	1	1,303
Percentage of total	46.2	53.7		100
1968	672	769	2	1,443
Percentage of total	46.6	53.3		100
1969	868	857	4	1,729
Percentage of total	50.2	49.6		100
1970	1,142	1,164	(1)	2,306
Percentage of total	49.5	50.5		100
1971	1,605	1,730	(1)	3,335
Percentage of total	48.1	51.9		100
1972	1,775	1,775	(1)	3,550
Percentage of total	50.0	50.0		100
1973	2,222	1,908	(1)	4,130
Percentage of total	53.8	46.2		100
1974	2,577	2,027	(1)	4,604
Percentage of total	56.0	44.0		100
1975	4,664	3,612	(1)	8,276
Percentage of total	56.3	43.6		100
1976	9,100	6,971	(1)	16,071
Percentage of total	56.6	43.4		100

[1] Beginning 1970 stock bonus plans were included with profit-sharing plans.

ATTACHMENT III

HISTORICAL ANALYSIS OF CORPORATE TYPE INITIAL QUALIFICATIONS

	Pension or annuity plans	Profit-sharing plans	Stock bonus plans	Total initial qualifications
1967	11,292	9,205	25	20,522
Percentage of total	55.0	44.9	0.1	100
1968	12,896	10,864	22	23,782
Percentage of total	54.2	45.7	0.1	100
1969	14,692	13,346	37	28,075
Percentage of total	52.3	47.6	0.1	100
1970	16,512	16,062	(1)	32,574
Percentage of total	50.7	49.3		100
1971	18,171	22,493	(1)	40,664
Percentage of total	44.7	55.3		100
1972	28,265	21,070	(1)	49,335
Percentage of total	57.3	42.7		100
1973	33,830	25,775	(1)	59,605
Percentage of total	56.8	43.2		100
1974	32,899	27,020	(1)	59,919
Percentage of total	54.9	45.1		100
1975	15,321	14,722	(1)	30,043
Percentage of total	51.0	49.0		100
1976	10,996	14,824	(1)	25,820
Percentage of total	42.0	58.0		100

[1] Beginning 1970 stock bonus plans were included with profit-sharing plans.

Senator NELSON. My memory may not be right on this. Does the statute require that when an application is made for termination that a reason be given for the termination?

Mr. WOODWORTH. The IRS requires it.

Senator NELSON. Of these 24,000 terminations, do you have computation of the reasons given?

Mr. WOODWORTH. Let me see. Yes; for those 2 years—I am sorry, it is a 15-month period from October 1, 1975 to December 31, 1976. Change of ownership accounted for 5.6 percent of the total, liquidation of the employer accounted for 13.4 percent, adverse business conditions accounted for 39.3 percent, burden of ERISA accounted for 20.1 percent, adoption of new plan accounted for 7.9 percent, and merger into a new plan accounted for 2.3 percent and closure of plant accounted for 1.6 percent.

Then there were others, 9.8 percent, which I hope will add to 100 percent.

Senator NELSON. You said 20 percent——

Mr. WOODWORTH. The burden of ERISA.

Senator CURTIS. If you would yield, is it not entirely possible that some who gave adverse business conditions as a reason would fall in there because of the greater liability on the owners in reference to ERISA to make them look at their business process to see if they could carry on?

Mr. WOODWORTH. That could well be, Senator Curtis. Another factor, however, that cuts a somewhat different pattern is the fact that in some cases we understand that they terminated plans because it was better for the individuals to set up IRA's. How much that accounted for, we do not have statistics for, but that was clearly an important factor.

I would suspect that another important factor was the fact that some of them were not adequately funded and were not anxious to become adequately funded and were required to do so by the act. It is hard to sort these reasons out. On the one hand, they can say whatever reason they want down there and it is probably often a combination of many different factors.

Senator NELSON. Did I understand your testimony to be that it is not necessary that the business give a reason; and that no matter what the reason is, there will be automatic termination if it is requested?

Mr. WOODWORTH. I understand that the IRS—I believe they have the right to do so—requires a reason in order to justify the issuance of the determination letter.

Senator NELSON. It does not make any difference what the reason is, there is no ground on which Treasury, under the law, could refuse to grant permission to terminate?

Mr. WOODWORTH. It is our understanding that there has to be a justifiable reason to sustain the qualification status, but there are various—I suppose there are some things they could put down that are not a justifiable reason.

Senator NELSON. When you say "justifiable reason," does the Treasury list what are "justifiable" or "are not justifiable?" If you require justifiable reasons, it would appear that there are grounds on which IRS could refuse to terminate.

Mr. WOODWORTH. I do not know what they are. I do know that they have permitted it on the various grounds that I have listed. There may be other grounds on which they have said that reason was inadequate, or something of that sort, I do not know.

Senator NELSON. If somebody submitted an application and said the reason I want to terminate is: "the horrendous amount of paperwork that the Labor Department and IRS has imposed upon us, it is a big mess and we do not want it," is that an acceptable reason?

Mr. WOODWORTH. That would be accepted; yes.

Senator NELSON. Thank you, Mr. Assistant Secretary.
Senator BENTSEN. Senator Curtis?
Senator CURTIS. Thank you, Mr. Chairman.

I am delighted that these hearings are being held. I am pleased that the executive agencies are anxious to help us improve this law. Never has there been any legislation such as ERISA coming out of this committee that has disturbed me more and has created a lot of problems.

As for myself, I was very much involved in the IRA and was not too thoroughly familiar with the private pension plans as a total. At the time that we considered this legislation, there were a few cases that were held up, more or less horror cases, that working men and women expected a pension under the old law and something happened, they never got it. There were not too many of those. There were a lot more not because of failure of pension plans but the failure to create new plans, to extend the program to reach more people, than the termination of plans.

With the cooperation of the college of business administration, we had a panel in Lincoln, Nebr. There was considerable interest in the IRA. I think that the State came in also. All day long no one asked a question, how do I start a pension plan. They said, how do you get out?

The Government destroyed a lot of pension plans before they were ever born.

As I say, I think the Congress has a very grave responsibility here and I would hope that we could work something out. I hope also that we will not hold it back for some big Government reorganization plan. This is so important that it should be considered as a separate plan.

I have a few questions.

Mr. Woodworth, ERISA provided a transitional provision to section 414 which allowed so-called parties of interest time to conform with fiduciary provisions. Part of this time expires on June 30 of this year, does it not?

Mr. WOODWORTH. Yes.

Senator CURTIS. One method provided to conform was to obtain an exemption from the so-called prohibited transaction rules either on an individual or class basis which you mention on page 2 of your testimony. That is correct, is it not?

Mr. WOODWORTH. Yes; that is correct.

Senator CURTIS. My question is what are the Departments doing to aid those whose exemption requests are pending and may not be acted upon by June 30?

Mr. WOODWORTH. The Department of Labor and the Internal Revenue Service have entered into an agreement to streamline the handling of exemption cases and we believe that it has resulted in a speed up in the disposition of these cases.

Some statistics have indicated that only 12 final exemptions have been issued by the two agencies out of more than 600 applications. However, by the end of April, the agencies had issued 14 final or proposed joint exemptions and a very large number of cases have been closed for denial of exemptions and other reasons. Over 25 percent of the joint exemption applications have been disposed of by the Internal Revenue Service.

In addition, the resolution of a small number of class exemptions would allow a relatively large number of other cases to be closed.

Senator CURTIS. I am encouraged by the progress, but what happens when the curtain goes down on June 30. That is the time fixed in the statute, is it not?

Mr. BURKHARDT. If it were to happen that we were not to have our exemption procedures ready—these are mostly insurance brokers that we are talking about here, insurance companies and brokers——

Senator CURTIS. Small insurance companies?

Mr. BURKHARDT. Yes.

We would be prepared to extend the period if we were not ready, but we intend to be ready by that time.

Senator CURTIS. That is the Labor Department?

Mr. BURKHARDT. We are working jointly on this.

Senator CURTIS. Both departments concur on that?

Mr. BURKHARDT. Yes.

Senator CURTIS. If it becomes necessary, there will be an extension?

Mr. BURKHARDT. That is correct.

Senator CURTIS. Dr. Woodworth, in your testimony suggesting that IRS and Labor give strong consideration to rules in the areas of greatest competence, how would you avoid confusion and expense to the practitioner who has to figure out these rules?

Mr. WOODWORTH. I am not suggesting that that be left to the practitioner in that regard. I am suggesting that there be statutory provisions which would divide up the various activities between the Department of Labor and the IRS and, as a result of that, that that division be made by looking at the particular areas of competence of the two agencies, although I also said that there are some, while you may generally do that on a very broad basis, which is essentially what Senator Bentsen's bill does, that there may be some areas of particular concern within these broad areas which might have to go contrary, in a smaller area, to the general rule.

I think the main thing, as far as those on the outside are concerned, is to get a clear rule as to what agency handles which particular provision and to make it clear that they are the only ones that handle that provision. That is what we are trying to work toward and achieve.

IRS and Labor are right with you, trying to work that out.

Senator CURTIS. Generally IRS gets matters of participation and funding.

Mr. WOODWORTH. The bill does that, and we acknowledge those are areas of competence of the IRS.

Senator CURTIS. Does the Labor Department have responsibilities in prohibited transactions?

Mr. WOODWORTH. The bill does that.

Senator CURTIS. Where does owner liability come in? Liability on the part of the owner?

Mr. WOODWORTH. I think with PBGC.

Senator CURTIS. With what?

Mr. WOODWORTH. The Pension Benefit Guaranty Corporation.

Senator CURTIS. It seems to me that Congress should be in that area too.

I just believe that we have gone too far there, that we have created a situation where tens of thousands, way more than that, individuals will never see a pension plan organized in their company, if we insist on such a provision. I want to say that I followed with a great deal of interest the questioning by Senator Bentsen. I wholeheartedly support that line of questioning and the objective that he seeks.

It seems to me that clearly we went too far in this field and when we do that, we not only deprive our citizens of the benefits but we also restrict the activity to the strongest, not necessarily to the honest and reliable, but those institutions with superior strength who can somehow withstand the storm and have sufficient employees and Departments and personnel to cope with decisions.

I am convinced that we have done more harm than good to the rank and file of the employees with ERISA than we have done good.

Mr. Chairman, that is all I have.

Senator BENTSEN. Senator Matsunaga?

Senator MATSUNAGA. I have no questions.

Senator BENTSEN. Let me say in defense of ERISA, I really do not hear anyone seriously debating vesting or funding provisions. We said to 30 million Americans in ERISA that when you reach retirement those savings of yours are not going to turn to dust. We are going to give you the same kind of protection that you have when you go down to the bank and make a deposit. We are going to give you the same kind of protection that you have in that savings and loan when you put it into a savings account.

I think that ERISA had a wonderful objective. I think that it accomplished much, and I think that the bill we passed in the Senate in 1974 was an excellent bill. I think when we got to the problem of trying to compromise the differences with the House bill that we ended up with all kinds of duplications of effort, conflicting jurisdictions, and we buried this thing in paperwork, and that is what we have to straighten out, and that is what I am trying to do with this piece of legislation.

As I understand what has been said thus far by Treasury, they, too, want to see a clarification of jurisdiction, a division of the responsibilities. They want to see that clarified, and we will try to help in that regard.

I am urging very strongly that we not wait, that we push that, to try to get a result. I do hope they will give further consideration to the limitation of the amount of stock in a corporation held by a pension manager to protect that pension beneficiary. The unintended effect of the prudent man rule was that this source of capital to new companies in this country dried up and that the so-called basket clause of 1 percent or 2 percent has worked very well in this country for insurance companies and it in no way has abused policyholders and we should have something akin to that in the way of legislation.

Dr. Woodworth, do you have any closing comments?

Mr. WOODWORTH. No; except to say generally while there may have been areas where perhaps we went too far in the pension act to start with, it seems to me that it has served a good purpose of putting pension funds on a much sounder basis and footing than they were before and I agree that there are problems you have to work out, and I can pledge you the cooperation of the Treasury Department toward that objective, and I know from discussing this with the Labor Department representatives that they also would gladly work with us in working these problems out.

Senator BENTSEN. There have been suggestions that we ought to wash our hands of both Departments and that a new administrative agency ought to be created. Those suggestions have been made on the House side, as I understand it, that you have a new Employee Benefits Administration, that we forget about any areas of competence or experience that your Departments have.

Would you care to comment as to the practicability of that approach?

Mr. WOODWORTH. I suppose that plans of that type may be subject to OMB review. I personally have the feeling that to set up a brand new agency would be to neglect all the experience and lessons that have been learned in the development of the existing plans by the Departments of Labor and Treasury and my own reaction to that would be that it is the best way to assure that the uncertainty and furor continues for an indefinite time ahead.

Senator BENTSEN. We would have three agencies then. I can imagine IRS still having authority to go in and check to see that it truly qualifies and it stayed qualified to prevent tax abuses.

Mr. WOODWORTH. The Service would almost have to go in. If tax deductions are taken, I do not see how you can say that they should not go in and say whether those deductions were properly taken or not.

If that is true, acting in that way does not put the IRS out and I think you would find there are certain areas where it would be possible to remove the Department of Labor in their efforts in that regard.

Senator BENTSEN. If you really want something disruptive to pension plans in this country, create a new agency and have three of them involved in there and see how long it takes for it to develop confidence, understanding, and staffing.

I certainly do not agree with that approach. I am pleased to hear your comments.

Thank you very much.

Now we have, Mr. Burkhardt here, Assistant Secretary of Labor. We would be delighted to hear your statement.

I noticed that comments were made about the area of responsibility. Would you like to comment as to your competence in that area?

Mr. Burkhardt.

STATEMENT OF HON. FRANCIS X. BURKHARDT, ASSISTANT SECRETARY OF LABOR FOR LABOR-MANAGEMENT RELATIONS, ACCOMPANIED BY STEVEN J. SACHER, ASSOCIATE SOLICITOR FOR PLAN BENEFITS SECURITY, U.S. DEPARTMENT OF LABOR

Mr. BURKHARDT. Senator, I do not have a prepared statement. I can respond to questions that your committee might have with regard to this legislation.

If you want me to respond in terms of objectives, as Dr. Woodworth has said, the objectives of your bill are sound. There is a real need to cleanly define areas of responsibility. It is an obligation we have to plan participants beneficiaries as well as those who are responsible for fund administration. It is important that people know who is protecting whom.

If it is a tax question, the people who are administering the plan, who are setting it up, I think those questions rightly belong in the Treasury Department. I think when you are talking about our particular program it is important to note that we have had almost 20 years of experience under the Welfare Pension Plans Disclosure Act and we have had a substantial operation in terms of the pension plans that existed under that particular act. We did what was possible under that law.

The other thing that is important to remember, we are dealing with a community clientele of perhaps 40 million participants; 25 million or so are covered under collectively beneficial contracts. They negotiate the benefits, and in many cases they negotiate the contributions.

The impact of ERISA, the regulations and the administration of contract laws all come back to the collective bargaining table in one fashion or another. I think that the Labor Department, over the years, has been received by workers and the labor movement as a principal source of information in this area.

I personally agree with your comments with regard to setting up still another agency on top of the two agencies that already exist. I believe that there would be a considerable amount of overlap.

I think the most important thing is that with Treasury Department—and we are both new at this particular game, not new in terms of the subject matter, but new in terms of the bureaucracy and how you negotiate these things—but we can work out and clean up some of those areas of responsibility. As a matter of fact, we had already scheduled a meeting with Treasury at the Assistant Secretary level next week sometime. At that time we will be looking at some of the very same areas that your bill addresses itself to.

Senator BENTSEN. Let me tell you, then, since you are new to the bureaucracy, that if you do not want us to proceed on our own without your counsel and advice, you had better give it to us fairly soon because we are going to push this and we would like to have your counsel and advice as to how you think the jurisdiction should be divided.

Mr. BURKHARDT. You can be sure that we are beginning now to look into these areas and to define them on paper and to work out agreements by which we can have common or single filing forms and dates looking into the length of time that plans have to file; and how we should handle summary plan descriptions. All of these things will be addressed in our meetings. I cannot say how long that will take, whether it takes in terms of 2, 3, 4 months. I do not have a crystal ball to predict exactly how long it will take us to satisfy the two agencies. Even then your committee may not be satisfied. You may still want to proceed along these particular lines, but we will keep you informed of our progress and we will let you know what kinds of arrangements we can work out on a voluntary basis.

Senator BENTSEN. Senator Nelson, would you like to comment?

Senator NELSON. If they have 1 month to do it, they will do it in 1 month; if they have 1 year, they will do it in 1 year. We all know the answer to that. You have had one-half year now.

Mr. BURKHARDT. I was checking with Senator Packwood's question, whether I had even been here 5 weeks—he said he sent me a letter 5 weeks ago. I am not even sure I was on the job 5 weeks ago. He is right and there is a letter in there. I have to apologize to him—he is not here. But he will have a response by tomorrow. I can guarantee you, however, that I have never seen it. We have only been on the job about 6 weeks.

Senator NELSON. I was not talking about you personally; but the problem has been there. Our two committees have had hearings before—in February 1976 [1]—and the Paperwork Commission published its recommendations 6 months ago.[2] Yet the response drags on and on. All I am saying, I do not know why it is so complicated, you could not get together, you know. If it were a lawsuit, you could settle it in 3 days. I do not understand why you cannot do it in 30 days. What is the problem?

Mr. BURKHARDT. There are many problems. They are all negotiable, I think. I am a practitioner of collective bargaining and negotiation and I think that any issue, any problem of this type, can be worked out by people and I think we ought to be given the opportunity to try that.

Senator NELSON. You are new but the issues have been there for months, for years. All kinds of complaints are on the record, yet the delay goes on and on and on and on. I am a great believer in getting things done. How could you conceivably spend 30 days on it? I do not know how you could spend 30 days on such a problem. If you sat down, I would think, you know, in two 8-hour days——

Mr. BURKHARDT. There are a number of things with these forms that have to be worked out, the questions of who is going to collect the information, how the information is to be shared between the agencies, what kind of accessibility to that information would there be. When, for example, we are doing an investigation into a prohibited transaction or some sort of violation of fiduciary responsibilities, we will want access to those files, and the sharing arrangements have to be worked out on a sound basis.

I do not think we should make mistakes as we did in the past of issuing regulations that then had to be changed and probably created many of the problems we have today. I would like to approach it on a little more professional basis and get this thing worked out.

Senator NELSON. Are you talking about all the problems, including paperwork and reporting duplication?

Mr. BURKHARDT. Duplication of work, filings, sure. These are where most of the complaints are.

Senator NELSON. Fine. I hope we are not back here 6 months from now saying, "why have you not done it." I do not know why 30 or 60 days is not enough time.

Senator BENTSEN. Senator Curtis?

Senator CURTIS. I have no questions.

Senator BENTSEN. Senator Matsunaga?

Senator MATSUNAGA. I have no questions.

Senator NELSON. Can you get it done in 60 days? Is there any reason why you cannot?

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[1] "Paperwork Requirements of the Pension Reform Act of 1974." Joint Hearings before the Subcommittee on Private Pension Plans and the Subcommittee on Financial Markets of the Senate Finance Committee and the Select Committee on Small Business, Feb. 2 and 3, 1976.

[2] "The Employee Retirement Income Security Act," a report of the Commission on Federal paperwork, Dec. 3, 1976.

Mr. BURKHARDT. I cannot answer that question without having had the first meeting. We have our own program pretty well defined and I am sure IRS has theirs. We will not have the first meeting until next week.

Senator NELSON. Next week is the first meeting?

Mr. BURKHARDT. Yes.

Senator NELSON. Next week why do you not discuss this exact point and then let us know how soon you will have this whole thing worked out. Can you do that?

Mr. BURKHARDT. We certainly can.

Senator NELSON. I think we ought to get it done. No use in delaying.

Senator BENTSEN. Mr. Secretary, your predecessors and staff below the Secretary level, people who are the same people now who were there then have been working with this problem for many, many months and surely have done a great deal of the groundwork now and are just waiting for the policy decisions that you folks at the Secretary level would make.

Mr. BURKHARDT. I think that is true. There has been a lot of work done. We do have the areas identified that we are going to negotiate. I am sure they have theirs. As you say, they have been working on this for problably the last 1½ years. They would be expected to be well along defining the problems. Finding the solutions is something else.

Senator NELSON. Do you have any comments concerning the limitations on stock ownership by the pension funds?

Mr. BURKHARDT. In terms of what, the leeway?

Senator BENTSEN. The legislation puts a limitation on those pension funds where you have assets in excess of $1 billion, putting a limitation on the ownership of stock in one corporation at 5 percent.

Mr. BURKHARDT. Not on the pension plans, it is on the pension managers.

Senator BENTSEN. That is correct.

Mr. BURKHARDT. There are only four pension plans in the whole country with assets over $1 billion. You are talking about the banks and trusts.

Senator BENTSEN. Yes.

Mr. BURKHARDT. I am a believer in the antitrust laws and breaking up economic concentration. I am not sure that this particular provision will really achieve that result. As Dr. Woodworth has said, the question may be a better one for the Securities and Exchange Commission if we are talking about that kind of breaking up of the control that an individual trust will have over a specific company.

Senator BENTSEN. I am trying to protect, in this situation, the beneficiary, the pension holder. I think you have an undue risk when you have an accumulation of stock in one corporation where it can run 10, 15, 20 percent, as we have seen in some instances and some of these pension managers that get locked in, and they find themselves in the very difficult position as far as protecting the pension beneficiaries, and these pension funds are growing at an incredible rate.

You are seeing more and more of a concentration of the management of them in very few hands. That means they have a tendency of having to go into very large corporations, so they have to float to get in and out and turn, and the other manager has the same problem and he goes into the same ones too often. Then you get the herd instinct. They follow each other.

Mr. BURKHARDT. Exactly.

I think the question of divestiture and mixing of portfolios, could be done in a number of ways. It is just as bad to have all of your stock in buildings that are in San Francisco, for example. If you ever had an earthquake, you would have a problem. It is just as bad to have all of your stock in the same company or a mix of it in terms of all equity.

There are a number of areas, number of concerns, that are just as important. Yours is a very important issue. I am just not convinced in my own mind that this particular solution, the 5-percent tax solution, will really achieve the desired result.

Senator BENTSEN. Mr. Secretary, it will not solve all of the problems and it will not give protection to everybody in this country.

What we are trying to do is take this one step at a time, taking care of those things that we think are obtainable and achievable.

Mr. BURKHARDT. I think I would have to take a longer look at that. I read your remarks in the Congressional Record when you introduced the concept on January 18th and tried to do a little analysis in terms of how many trust funds we were really talking about, how many trust funds you were really talking about, to get a fix on that. We are still looking at that.

Senator BENTSEN. I can tell you how many we are talking about. According to our latest figures, we are talking about approximately twenty banks, we are talking about twelve of the nation's largest insurance companies and several large self-managed pension plans. That is what we are talking about.

Are there any other questions of the Secretary?

Senator MATSUNAGA. Mr. Chairman?

Senator BENTSEN. Senator Matsunaga?

Senator MATSUNAGA. Mr. Secretary, you speak of not only the possibility, but I gather the probability of you being able to get together with the Treasury Department to work out your differences and areas of jurisdiction.

According to the figures that I have, in 1976, I think these were the figures from Senator Nelson, 17,200 pension plans were terminated as compared to less than half the previous year, less than one-fourth the previous year, and so on.

Do you feel that by getting together with the Department of Treasury you would be able to lessen the number of termination of pension plans, or do you feel that even by your getting together and defining your areas of jurisdiction you will not be able substantially to save any of these pension plans now being terminated at an astounding rate?

Mr. BURKHARDT. As I remember Dr. Woodworth's termination list he mentioned 20 percent of them were because of alleged ERISA problems. The other 80 percent, I do not know what the reasons may have been for termination. We cannot control the economic conditions in the country at any specific time. I doubt even coming together will achieve anything in that area.

Some of the areas we listed I do not think we could reasonably be expected to touch on at all.

Senator MATSUNAGA. We, as Members of the Congress, are primarily interested in the beneficiaries of such plans. Here is a man who works for 40 years, puts in his monthly contribution and suddenly finds that he is without any pension.

Can that still happen?

Mr. BURKHARDT. We have the Pension Benefit Guaranty Corporation that insures against that for a single employer plan, and for a multiemployer in 1978. They pay an insurance premium. They have been paying a premium of $1 per member per year.

Senator MATSUNAGA. Of the 80 percent failing, or terminated in some way, how many percent of the pension is protected by the insurance plan?

Mr. BURKHARDT. We could not give you an exact number. It would be at least half, or probably more. We could supply that kind of information.*

It is important for you to know that the corporation itself is right now undertaking an examination of the terminations they had filed with them in 1976. Hopefully it should be out this Friday. You should get a picture there of the kinds of employees that were protected on the plans that were filed for termination.

Senator MATSUNAGA. That is with as many as 17,200 failing a year, up to 50 percent is not enough, is it?

Mr. BURKHARDT. I said that it would be at least that. First of all, you have to remember—is your 17,000 80 percent with the 23,000 that was mentioned by Dr. Woodworth? We are getting a little far afield with numbers here.

Senator MATSUNAGA. According to figures which were given to me by Senator Nelson's staff, during 1976, there were 17,200 pension plans which either failed or were terminated. That is the total for all of 1976.

What I am saying here is that after a pensioner has contributed all his years of labor, up to 20 percent protection by a pension plan is certainly not enough.

Mr. BURKHARDT. An individual is not protected up to 50 percent. If he was in a plan that was paying into PBGC, he is protected at the time it was terminated. That individual is fully protected up to the point that he has fulfilled the vesting requirements under the particular plan or under the law.

Senator MATSUNAGA. What is this figure of 50 percent?

Mr. BURKHARDT. Those are the number of plans. I thought you were asking the question of what percentage of those plans which had terminated were covered by PBGC.

Senator MATSUNAGA. I am talking about the pensioner's interest. He is protected up to 100 percent.

Mr. BURKHARDT. There is a maximum of $820 a month for all practical purposes. Most plans do not provide for that kind of pension benefit anyway.

I would say in most all of the cases where they meet the PBGC requirements that they are protected, yes.

Senator MATSUNAGA. Am I to assume from your statement that of these 17,200 plans we terminated, none of the pensioners suffered at all?

*See letter on p. 61.

Mr. BURKHARDT. No, I cannot say that. I do not know what percent of the plans were covered under the Pension Benefit Guaranty Corporation.

Senator MATSUNAGA. There is no requirement that they all be in the insurance plan?

Mr. BURKHARDT. If it is a defined benefit plan, if the individual was guaranteed a certain benefit, then the plan is required to be covered. The participant in such a plan would have full protection, yes. But there are plans that are not defined benefit plans.

Senator MATSUNAGA. There definitely needs to be further work done in this area to protect the other 50 percent.

Mr. BURKHARDT. I agree.

Senator MATSUNAGA. I have no further questions.

Senator NELSON. The insurance fund is $1 per enrollee, covered enrollee, per year, right?

Mr. BURKHARDT. Yes, for single employee plans, 50 cents for multiemployee plans.

Senator NELSON. What is the status of that fund now?

Mr. BURKHARDT. I am informed it is fully solvent and it paid back a small loan that it had from Treasury when it was initially set up of $200 million, something like that. I do not know the exact asset situation right now. I seem to recall the number is around $300 million but I'm not sure.

Senator NELSON. $300 million in the fund now?

Mr. BURKHARDT. Yes. We can get you the numbers. This is really an area for the Pension Benefit Guaranty Corporation. They have their own set up there and would know the numbers better.

Senator BENTSEN. I think we have Mr. Henry Rose in the audience now.

I understand you were not expecting to be called. If you do have that information, you may answer Senator Nelson.

STATEMENT OF HENRY ROSE, GENERAL COUNSEL, PENSION BENEFIT GUARANTY CORPORATION

Mr. ROSE. I would like to be able to give it to you in writing for the record. I can give you a rough idea.

The last figures I saw there are $75 million in assets.

Senator NELSON. $75 million in assets?

Mr. ROSE. Yes.

Senator NELSON. What are the annual receipts?

Mr. ROSE. Annual receipts from premiums are somewhere between $25 and $29 million.

Senator NELSON. Between $25 and $29 million?

Mr. ROSE. Yes.

Senator NELSON. That changes as the number of covered employees changes; and you say you have around $75 million of assets in the fund now?

Mr. ROSE. I believe so. I would like to clarify it for the record.

Senator NELSON. I would like for you to submit the accurate figures, precise figures, for the record. How much has been paid out since it was started?

Senator BENTSEN. Mr. Rose did not know I was going to call on him. I say that in his defense.

Mr. ROSE. I appreciate that, Senator.

We are paying our approximately $550,000 a month now to some 6,500 persons. I do not know what the total cumulative payouts have been offhand.

Senator NELSON. You are paying out about what?

Mr. ROSE. About $550,000 a month.

Senator NELSON. Per month?

Mr. ROSE. Yes.

Senator NELSON. To some 6,500 employees?

Mr. ROSE. I believe that is it.

Senator NELSON. Can you submit for the record how much that longterm obligation is, and what the projected status of the fund is under current circumstances?

Mr. ROSE. Certainly. I would be happy to.

Senator NELSON. Is the premium high enough to cover the obligations?

Mr. ROSE. We anticipate that the premium will have to rise.

Senator NELSON. Do you have projections to support that?

Mr. ROSE. We have some studies that are far advanced to support that, yes, sir.

Senator NELSON. When will you be making such a proposal?

Mr. ROSE. The studies will be completed sometime this spring. Our board of directors will review them and we may come forward to your committee and others some time this summer.

Senator NELSON. Do you have any notion as of now what premium changes you will be requesting?

Mr. ROSE. No, I think it is premature to say.

Senator NELSON. Thank you, Mr. Rose.

Senator BENTSEN. Mr. Rose, you are the General Counsel, as I understand it, for the Corporation?

Mr. ROSE. Yes, Mr. Chairman.

Senator BENTSEN. Thank you very much. If you would try to develop the additional information that Senator Nelson requested for the record it would be helpful to us.

Mr. ROSE. I will be happy to supply it.

[Mr. Rose subsequently supplied the following information for the record:]

PENSION BENEFIT GUARANTY CORPORATION,
Washington, D.C., May 27, 1977.

Hon. LLOYD H. BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in further response to the questions concerning the pension plan termination insurance program that were raised in the course of the hearings held by the Private Pension Plans and Employee Fringe Benefits Subcommittee on May 10, 1977.

As you know, most private pension plans that promise a defined benefit are covered under the plan termination insurance provisions of Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA"). This includes approximately 90,000 pension plans, covering over 30 million people. When a covered plan terminates, the Pension Benefit Guaranty Corporation ("PBGC") guarantees the payment of basic pension benefits (within statutory limits) regardless of the terminated plan's financial condition. By law, a covered plan must notify PBGC before it terminates.

From September 2, 1974 through April 30, 1977, the PBGC received 16,141 notices of termination. In calendar year 1975 the total was about 4,000, rising to about 7,300 in calendar year 1976. In recent months the rate of plan terminations appears to be declining, as 1,987 notices were received in the first quarter of 1977.

While there has been a large number of covered plan terminations, the number of individuals who have lost pension coverage is not in proportion. Most of the terminated plans were quite small. All told, in 1975 and 1976, 260,000 people were covered by the plans terminated. Thus, while 10 percent of the plans initially covered by title IV of ERISA have terminated, those plans involved about one percent of the covered participants. Furthermore, PBGC estimates that in about 28 percent of the cases, a different type of pension coverage (for example, individual retirement accounts) was set up for the participants in the terminated defined-benefit plan. In view of the expressed interest of the Committee, I am enclosing a detailed analysis of terminated pension plans which have been processed by the PBGC, Analysis of Single Employer Defined Benefit Plan Terminations, 1976.

In most cases plan termination did not mean a significant loss of benefits that had already been earned. About 97 percent of the terminated covered plans thus far evaluated had sufficient funds to cover all guaranteed liabilities. 270 plans, involving 36,982 participants, terminated with inadequate funds to cover the benefits that are guaranteed by PBGC. As of May 2, 1977, the PBGC had become trustee of 102 of those plans, and is overseeing the continued payment of the participants' guaranteed benefits. Plan administrators of the remaining terminated insufficient plans have been instructed by the PBGC to continue benefit payments pending PBGC becoming trustee of those plans.

By law, the PBGC's guarantee of pension benefits is limited in several ways. At present PBGC cannot guarantee more than $937.50 in monthly benefits for a single participant. In addition, benefit increases made less than 12 months before plan termination are not guaranteed, and improvements made within 5 years before termination may not be fully guaranteed. Of course, PBGC only guarantees pension benefits to which participants were entitled on the date of plan termination. By May 2, 1977, PBGC was paying out $558,000 per month to a total of 6,569 retirees or their beneficiaries; 6,084 people had guaranteed deferred pension rights, and benefit payments will begin when they reach retirement age.

Our most recent year-end financial statement is for the 15-month period ending September 30, 1976. As of that date, the PBGC had collected $56.2 million in premiums paid by single employer plans and $10.4 million from multiemployer plans and had assumed approximately $144.5 million in liabilities attributable to benefit payments under terminated single employer plans. Taking into account administrative expenses, the assets of terminated plans assumed by the PBGC and the employer liability we expect to recover, as of September 30, 1976, PBGC's cumulative deficit was $41 million for single employer plans.

Although the single-empoyer program shows a substantial deficit, the PBGC's $72.8 million of cash and investments, as of September 30, 1976, placed it in a highly liquid position. PBGC's liabilities will be discharged by paying annuities over the remaining lifetime of pensioners and beneficiaries and thus only a small fraction of the total liabilities PBGC assumes are due each year. For example, at the end of fiscal year 1976, approximately $11 million in pension payments were being made a year on an annualized basis. The PBGC is now studying the probable need for a premium increase in order to avoid future deficits.

Enclosed is information describing the PBGC's program and its financial condition in greater detail.

I appreciate the opportunity to provide this information to the Committee and stand ready to assist the Committee further in any way I can.

Sincerely,

HENRY ROSE,
General Counsel.

Senator BENTSEN. Are there any other questions?

Thank you gentlemen for your attendance. These hearings will reconvene at 10 o'clock tomorrow morning.

At this point in the hearing record I would like to insert an excellent study prepared by Ray Schmitt, the pension expert at the Library of Congress, dealing with the termination of pension plans since the enactment of ERISA.

[The material referred to follows:]

STATEMENT OF RAY SCHMITT, EDUCATION AND PUBLIC WELFARE DIVISION, THE LIBRARY OF CONGRESS, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, D.C.

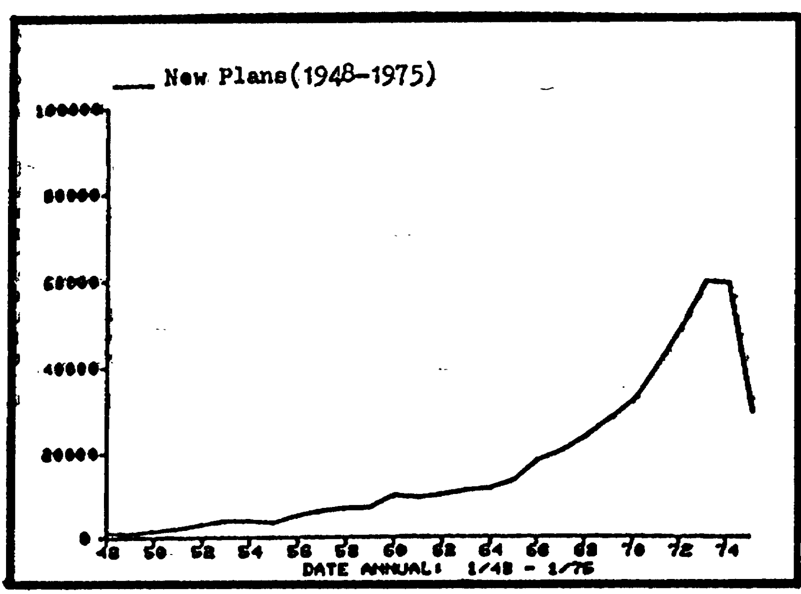
PENSION PLAN TERMINATIONS—What Do the Statistics Suggest?

Considerable concern has been expressed in recent months over the large number of pension terminations. Critics charge that the Employee Retirement Income Security Act of 1974 (ERISA) is the chief reason for the upsurge in plan terminations, whereas others believe that business and economic conditions are the primary reason. Congress is particularly concerned about the increase in the rate of pension plan terminations since it passed ERISA for the purpose of protecting the interests of participants in private pension plans and their beneficiaries. In shaping the legislation, Congress was cognizant that no employer had to provide a pension to its employees and tried to minimize any adverse effect that the legislation might have on the private pension system. But at the same time Congress was aware of the serious shortcomings that existed in the private pension system after almost 10 years of study and debate.

Since there is as yet only limited experience with ERISA, it is both difficult and premature to judge the impact of the law and whether the high rate of terminations experienced since enactment will continue into the forseeable future. It is therefore important to have additional information before any conclusions are drawn concerning the effects of the law. In this regard, both the Labor Department and the General Accounting Office are engaged in studies to determine the effect of ERISA on plan terminations. In the interim, the following information may be useful when viewing the termination statistics.

How many pension plans have terminated?

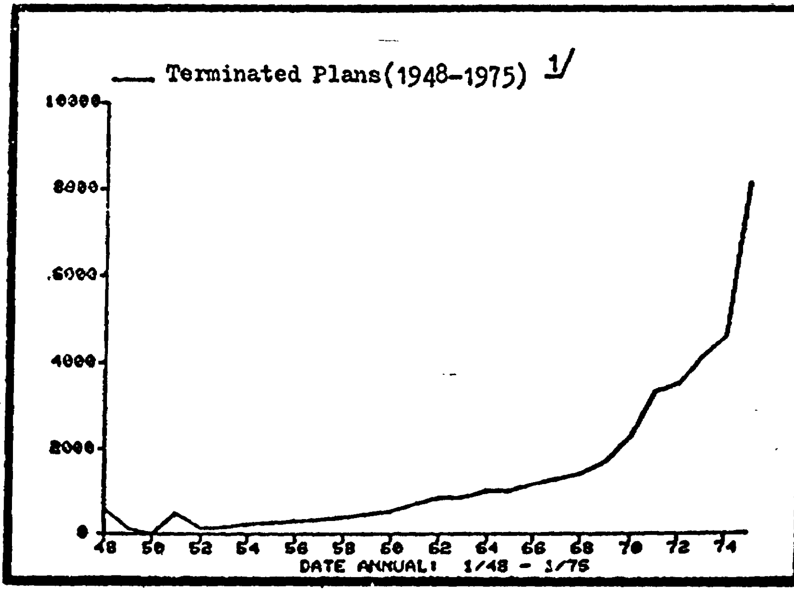
Statistics are available on the number of plans obtaining and maintaining tax-qualified status under the Internal Revenue Code. The data show that there have been a substantial increase in the annual number of plan terminations and a decrease in new plan starts since the enactment of ERISA on September 2, 1974. The following graph shows that the number of new pension plans increased at a rather steady rate from 1948 to 1966. It then increased rather rapidly until 1973-1974 when the number of new plans leveled off at around 60,000. In 1975, the number of new plans dropped off sharply to about 30,000.



GRAPH 1

Plan terminations grew at a rather steady rate from 1948 until 1969. The following graph shows that from 1970 to 1974, the rate of terminations picked up reaching a significantly higher level in the period immediately after enactment of ERISA.

GRAPH 2



[1] It should be noted when viewing the termination graphs and statistics in this paper that a time lag exists between the date a notice to terminate a plan is submitted to IRS and the final action by IRS. The statistics in this paper reflect the reported IRS statistics without adjustment for this lag. In this regard, a study by the Bureau of Labor Statistics of plans that terminated between 1955 and 1965 indicated that on the average during a period of increasing terminations the number of actual terminations exceeded the number of applications acted upon by IRS during any period by 20 percent. Since the enactment of ERISA, the time lag has increased. The present IRS objective is to process the termination applications within 145 days of receipt.

Since the enactment of ERISA there has been a decrease in the annual ratio of new plans to terminated plans. During the ten years prior to enactment, the average ratio of new plans to terminated plans was about 14.4 to 1. In 1975, the ratio was 3.7 to 1, and only 1.2 to 1 during the first nine months of 1976. Furthermore, since enactment of ERISA most of the new corporate and self-employed plans have been of the defined contribution type (that is, profit-sharing and money purchase plans). Defined contribution plans are not insured by the Pension Benefit Guaranty Corporation (PBGC) and are not required to meet the funding standards of ERISA. During the period January–September 1976, only about 10 percent (1,330) of the 14,270 new tax-qualified plans were of the defined benefit type.

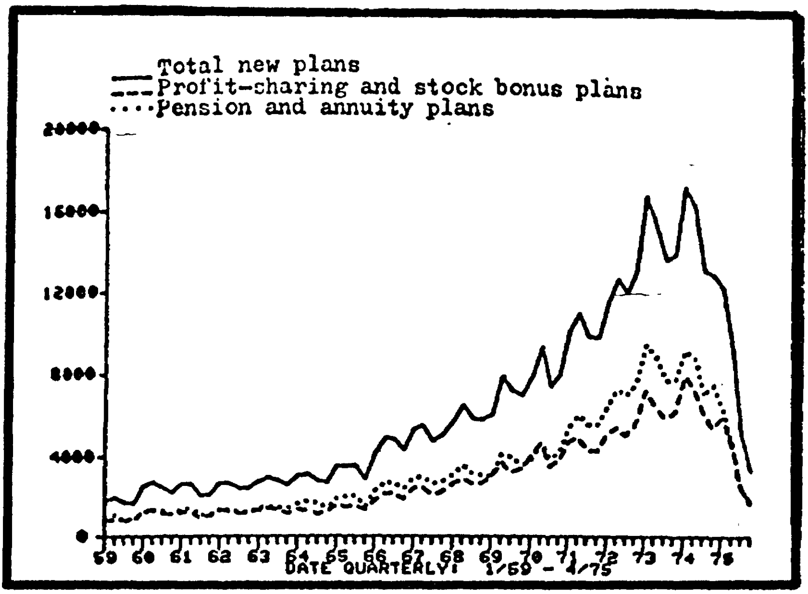
The following are the yearly totals of new plans and terminating plans from 1965 to 1976 together with the ratio between the two.

Year	Tax qualified corporate plans		
	New plans	Terminated plans	Ratio of new plans to terminated
1965	13,532	1,036	13.1
1966	18,183	1,210	15.0
1967	20,521	1,307	15.7
1968	23,782	1,443	16.5
1969	28,075	1,723	16.2
1970	32,574	2,306	14.1
1971	40,664	3,335	12.2
1972	49,335	3,520	14.0
1973	59,605	4,130	14.4
1974	59,385	4,604	12.9
1975	30,039	8,108	3.7
1976[1]	[2] 14,270	11,909	1.2

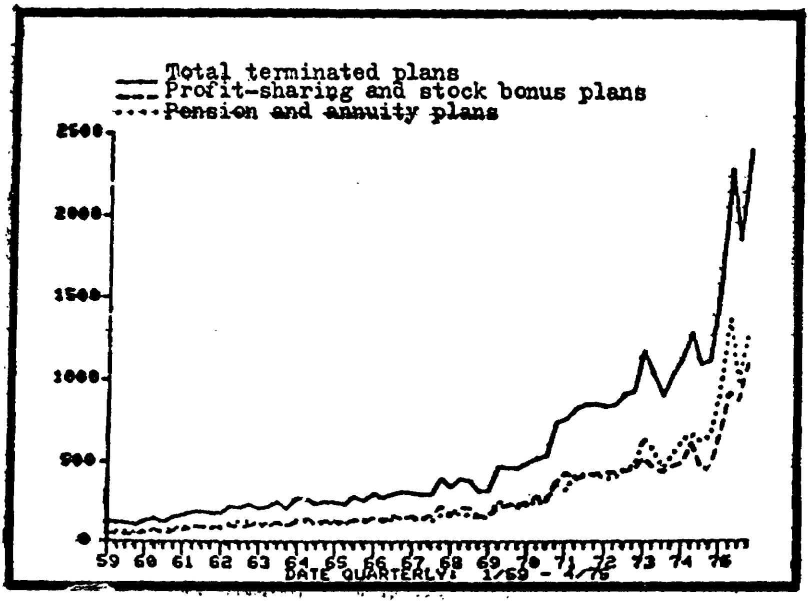
[1] Through September 1976.
[2] Includes a small number of plans for the self-employed.

Source: Internal Revenue Service.

Quarterly data are available on new and terminated plans since 1959. A breakdown is available for both profit-sharing and stock bonus plans, as well as pension and annuity plans. The following two graphs show that the number of new and terminated plans within each benefit plan category followed the same general patterns. In recent years, however, pension and annuity plans accounted for a proportionately greater amount of the increase in both new and terminated plans.



GRAPH 3



GRAPH 4

How many plans could have been expected to terminate?

Since plans have terminated in the past, it is reasonable to assume that they would continue to terminate in the future. But how many plans could have been expected to terminate notwithstanding ERISA?

The number of terminations takes on meaning as a measure of the impact of ERISA when compared with the number of plan terminations which might reasonably be expected in the absence of ERISA. Based upon historical trends and economic data, over 9,000 plans could have reasonably been expected to terminate in the two years following September 1974 ERISA may therefore only be responsible for the incremental increase over the anticipated number of plan terminations. However, this in itself is significant since the actual number of postenactment terminations (21,123) is over twice the extrapolated amount (9,132).[1]

What is known about terminated pension plans?

A limited amount of information is available for defined benefit pension plans that come under the termination insurance provisions of ERISA. These plans account for about half of all terminations.

On March 19, 1976, the Pension Benefit Guaranty Corporation released an analysis of single employer defined benefit pension plans that terminated during 1975. The analysis was based upon a ten percent systematic sample of terminated plans. Some of the highlights of this analysis are as follows:

In 35 percent of the plan terminations involving an ongoing employer, an intent to provide pension coverage to plan participants through another plan was cited.

Seventy-seven percent of the plan terminations covered by the insurance program did not indicate that ERISA was the reason for termination. Adverse economic conditions, change in ownership, or liquidation of the employer's business were typical of the cited reasons for plan termination.

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[1] The expected values for the 2-year period following enactment are projected from two regression equations estimated with quarterly data beginning with the first quarter of 1959 through the third quarter of 1974. These equations control for the effects of inflation, as well as historical and seasonal trends.

Twelve percent of the plan terminations covered by the insurance program indicated that ERISA was the reason for termination.

An additional eleven percent cited other reasons in addition to ERISA, such as adverse economic conditions.

The June 30, 1975, Annual Report of the Pension Benefit Guaranty Corporation provides additional information on terminating plans based upon a 20-percent random sampling.

The terminating plans in the sample average 30 participants.

Fifty-three percent of the plans covered fewer than 10 participants.

Thirty percent of the plans were less than 5 years old.

Some pension experts question the validity of the reasons cited by employers for terminating their pension plan. Under pre-existing IRS procedures (see Rev. Rul. 69–24, 69–25, and 72–239), if a plan were discontinued within a few years after adoption, an employer could lose prior years' tax deductions unless the plan were terminated for valid business reasons. Accordingly, a plan which had been in existence only a short period of time might be reluctant to cite ERISA as the primary reason for terminating so as not to jeopardize prior years' tax deductions.

In a November 5, 1976, news release by the American Society of Pension Actuaries it is stated that "According to 70 percent of participants in a recent survey of qualified plan practitioners, ERISA, not business conditions, is the major cause of the recent upsurge in plan terminations." Concerning a small number of new plans being formed, the release stated that "red tape, burdensome funding rules, and overly liberal eligibility rules" were the factors deterring new plans. Also mentioned were the fiduciary provisions of ERISA as well as the easy availability of Individual Retirement Accounts (IRA's) as an alternative.

Is the "Fallout" all bad?

While ERISA may have caused a number of plans to terminate, it is important to look beyond the termination statistics. Some employers terminating their plans, for instance, are reportedly converting to other types of employee benefit plans; other employers may be taking a "wait and see" approach before adopting a plan until all the regulations are out. Furthermore, it could be hypothesized that the "worst" is over. ERISA may have caused a number of "poorer" or marginal plans to terminate— precisely the type of plan which led to the enactment of minimum Federal standards.

While some individuals may have lost pension coverage. ERISA will increase the chances of other individuals participating in ongoing plans to earn pension benefits through the liberalization of the participation and vesting requirements. Thus, the net effect could be an actual increase in the number of individuals who may eventually receive pension benefits at retirement. Furthermore, individuals with vested rights under a defined benefit pension plan will receive those benefits (within certain statutory limitations) under the termination insurance program established by ERISA.

It should also be noted that the statistics on plan terminations do not reflect the number of people who may have been reasonably expected to receive benefits under the plans or what their current pension status is. Nothing is known, for instance, about how "good" the plans were; that is, how many participants of these plans had earned vested rights to benefits, how long an individual was required to work before benefits vested, or how much benefits each individual could have been expected to receive if the plan had not been amended to comply with ERISA. Many participants may have been covered by plans under which they would have received little or no benefits anyway. These individuals would at least now be eligible to save for their own retirement by setting up an Individual Retirement Account.

It should also be recognized that the economy has just experienced the most serious recession since Word War II. (The pension "boom" began shortly after the end of World War II.) As shown in graph 4, profitsharing plans which are exempt from some of the provisions of ERISA (i.e., funding requirements and termination insurance provisions) and which often had rather liberal participation and vesting provisions followed the same sharp postenactment termination increase. This suggests that some factors beyond the law contributed to the sharp increase in terminations.

The answers to these important questions may be available when the General Accounting Office and the Labor Department complete their termination studies. While the GAO study covers only defined benefit plans covered by the PBGO termination insurance program, the Labor Department study will cover all plans. The GAO study is expected to be completed in Summer 1977. The final report of the Department of Labor, however, will probably not be available until fall.

[Thereupon, at 3:45 p.m., the hearings in the above-entitled matter were recessed to reconvene Wednesday, May 11, 1977, at 10 a.m.]

PENSION SIMPLIFICATION AND INVESTMENT RULES

WEDNESDAY, MAY 11, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS OF THE
COMMITTEE ON FINANCE AND THE
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittees met, pursuant to notice, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the Subcommittee on Private Pension Plans) presiding.

Present: Senators Bentsen, Matsunaga, and McIntyre.

Senator BENTSEN. These hearings will come to order.

This morning we begin the second day of hearings on legislation to simplify our pension laws.

Unreasonably burdensome and costly reporting requirement, particularly for smaller private pension plans, will be counterproductive and may result in the cancellation of many good plans. A reasonable balance must be maintained between the necessity of protecting all pension plan participants from abuses and the necessity of avoiding a situation where many good retirement plans terminate simply because they are being buried in an avalanche of paperwork and redtape. Duplicate reporting requirements impose an unnecessary time and cost burden on businessmen, labor organizations and other administrators of pension plans.

There have been excessive delays in the promulgation of regulations and rulings. Some of my constituents have literally been waiting years for administrative rulings under ERISA. This is not an example of a Government which is responsive to the needs of its people.

Dual administration frequently results in some unacceptable, although unintentional, regulatory requirements. For example, pension plans are required by law to notify the pension plan participants and beneficiaries of certain changes in the plan. In order to comply with duplicate rules and regulations, one plan found it necessary to send three separate notification letters to participants—one letter to participants in order to comply with the rules of the Internal Revenue Service, a second letter, with virtually identical information, to comply with the rules of the Labor Department and still a third letter to comply with the rules of the Pension Benefit Guaranty Corporation—PBGC.

Our witnesses this morning include two previous administration pension officials—former Commissioner of Internal Revenue Donald

Alexander and former Administrator of the Pension and Welfare Benefit Program at the Labor Department William Chadwick.

I would like to first welcome former Commissioner Alexander, an outstanding public servant, who has the respect of all members of the Senate Finance Committee. During the past 3 to 4 years as IRS Commissioner, Donald Alexander has demonstrated his strong commitment to simplify the administration of our tax and pension laws. He has repeatedly provided invaluable assistance to the tax-writing committee of Congress and we are very pleased that we will continue to benefit from his expertise.

Commissioner Alexander.

STATEMENT OF DONALD C. ALEXANDER, FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. ALEXANDER. Thank you very much, Mr. Chairman. I deeply appreciate what you said, and I appreciate even more your longstanding and continuing interest in striking that reasonable balance that you described between establishing and protecting rights of participants and beneficiaries and not requiring so much in the way of regulation, in the way of duplicate regulation and in the way of paperwork and duplicate, sometimes triplicate, paperwork, as to impede and stunt the growth and vitality of our system of private pensions.

Mr. Chairman, I have a statement which I would like to submit for the record with your permission, and to summarize it.

I am pleased to have the opportunity as a private citizen to testify in support of your bill, S. 901, the Pension Simplification Act.

Senator BENTSEN. Let me interrupt. Today many members of the Finance Committee are down at the White House for a meeting. Some of them are not back yet. I am sure that we will have better attendance in a short time.

Mr. ALEXANDER. Thank you, Mr. Chairman.

When I became Commissioner of Internal Revenue back in May 1973, the move toward pension reform was well underway and it had started some years before that. It was moving in two directions at the same time: One, your bill to establish, maintain and protect rights of participants and beneficiaries and two, companion bills on the labor side. These bills were quite similar in content, but different in their jurisdictional approach.

The bills sponsored by the House and Senate Labor Committees provided for the administering agency to be the Department of Labor. The bills sponsored by the tax writing committees provided for the Internal Revenue Service to continue to have responsibilities, that it had had at least since 1942, to administer the strengthened provisions of law in respect to vesting, funding, and participation, as well as new provisions with respect to prohibited transactions and duties of those who administer plans—not what is written in the plan, but what is done by the fiduciary or administrator of the plan.

It is difficult enough for a single agency to administer a law soundly, particularly a new and complex law that affects a large number of people. Various groups within the agency, or within a department, have differing ideas and it is surprising when you readily achieve consensus. Consensus is slow to develop, frequently, and action is also slow even when you have one administering agency.

In the Internal Revenue Service authority and responsibility with respect to ERISA is assigned primarily to the Office of the Assistant Commissioner for Employee Plans and Exempt Organizations. The Chief Counsel plays a major role, however, as does the Tax Legislative Counsel in the Treasury Department.

The problems are compounded when another agency is assigned duplicate responsibilities and authority. There is an exponential increase in the delays incident to making decisions, the difficulties in arriving at consensus, and the delays in implementing decisions once made.

We tried to make the system work. It did not work as well as you in Congress expected, as the public expected, or as we expected of ourselves, despite our efforts.

Large backlogs have been built up, particularly in the prohibited transaction areas where the statute, in both the labor provisions and tax provisions, flatly prohibits plan fiduciaries and parties in interest from entering into certain transactions unless the agencies, both Labor and IRS make exceptions in situations that, among other things, are protective of the rights of plan participants and beneficiaries.

In cases like this, you can expect that there would be delays of the kind that you mentioned, Mr. Chairman.

Another problem is duplicative paperwork. That is a problem in which Senator McIntyre has a great interest, both in the Senate and as a member of the Commission on Federal Paperwork, on which I was privileged to serve. There we tried to arrive at common ground, a common form to be supplied at the same time to both agencies or better supplied only to one agency and the information given by that agency to another. Here again we encountered problems of the kind that you are describing.

Now, some of these problems have been worked out and some of them are being worked out, but you need a legislative solution. That legislative solution should be in the long range best interest of the employees and the employers, but it should not disregard the accumulated experience, the staff in place, and the knowledge acquired by the IRS which, for over 30 years, has administered provisions of law with respect to retirement plans. These legislative actions should not impede the current efforts to cope with backlogs and produce the meaningful guidance and assistance that is so badly needed.

If in the effort to solve every problem, however minor, including the possible overlap between ERISA and the Bankruptcy Act or the Freedom of Information Act or the Privacy Act, a massive bill is designed, I would question, in this real world, whether that massive bill could ever be enacted and, if enacted, whether the solutions that it contains might not be worse than the problems that it seeks to cure.

The soundest way to proceed is to eliminate overlapping jurisdiction by allocating responsibilities between IRS and Labor. That would leave IRS and Labor and the Pension Benefit Guaranty Corporation still in the picture, but the overlap between the Pension Benefit Guaranty Corporation and IRS is not really troubesome and the creation of a massive new agency is not going to solve all the problems of overlap.

If it were to solve them, then there would be some overlap in that very agency; you would be transferring overlap from one place to another place. I doubt that such a transfer would be particularly helpful.

Senator BENTSEN. Let me understand that. You are saying you think that creating a new agency, a new bureaucracy would not resolve all of the overlap.

We had some testimony yesterday to the same effect, that the IRS would still have certain areas that they would have to intervene in insofar as seeing if there was true tax deductibility and that sort of thing.

Mr. ALEXANDER. Yes.

Unless authority such as the right to determine what is reasonable compensation would be given to this new agency, there would still be tension, there still would be overlaps between a new agency and IRS. Our pension system is inextricably tied to our system of taxation, as you pointed out in your statement introducing S. 901. Massive tax benefits are granted to encourage our present system of retirement plans. These benefits may amount to well over $4 billion in taxes otherwise due but for these provisions in the statute.

IRS is the agency charged with administering the tax laws. It has the right and responsibility to conduct audits where necessary in fulfillment of this charge imposed upon it.

Granting a duplicating audit right and responsibility would create far more problems, in my judgment, than it would solve. Duplicate audits would obviously be bad, but failure to audit would be worse. It would leave a hole, a gap, of serious and growing dimensions as those perhaps with greater desire to reduce their tax obligations than desire to conform to what is expected of them, take advantage of this situation. I cannot see, as a practical matter, how enough of IRS' present authority could be transferred to a new agency without making a massive inroad on the tax system in a way that would make the cure worse than the kill.

Senator BENTSEN. You have more confidence in the Labor Department and IRS and this piece of legislation where I try to direct it toward their areas of competence and expertise.

How long do you think it would take a new agency, starting fresh with new people, to finally bring some order and some response to the private pension system?

Mr. ALEXANDER. The creation of a new agency would be very seriously disruptive. An order could be issued transferring all of the Internal Revenue people concerned with employee plans immediately to the new agency. If the order could be issued immediately, theoretically the people could be transferred and working. Actually, it does not work that way.

There would be bureaucratic jockeying for position. There would be the writing of position descriptions which would make the HEW Secretary's cook's position pale by comparison.

There would be further disruption as people tried to establish new slots and competed for the top slots. Problems in creating a new agency would make the present backlogs, the present delays, the present dislocations, minuscule by comparison.

Now I notice the bill introduced in the House proposes that if a new agency is created to take over the work presently conducted by IRS, Labor, and presumably others, there may be a delay in the effective date of creation of the new agency for 1 year.

As I see it, having had some experience in government and having been through the creation of the new office in Internal Revenue with the responsibility of administering IRS's authority with respect to ERISA, that year would be a year in which people would be doing very little constructive work on the issuance of long-delayed regulations, of long-delayed exemptions, of guidance to the public, but would be a year in which the new organization would be the focus of their attention. The year, I think, would be down the tube as far as meeting the objectives which those in the House, want, which you want, and which the agencies and the executive departments want, as well.

I think a new agency is the worst of the alternatives open to consideration in an effort to solve the problem.

Another solution is to give Labor the entire responsibility. Perhaps it might seem parochial of me to suggest that that is not the better alternative, but I think that suggestion is sound. The IRS has been in this business for a long time. The IRS has used its pre-ERISA power, the power to deny exemption or withhold exemption, reasonably well, but it needs additional powers and rights, specifically to safeguard and establish rights of employees. The use of the club instead of a pencil, even though the club is swung very carefully, is not the best solution.

So your bill, S. 901, remedies this defect in a sound way by giving the IRS flexible powers, like those granted to the Labor Department under ERISA. One of the objections that I have heard stated to assigning jurisdiction to IRS over vesting, funding, and participation and removing duplicate jurisdiction this way, is that IRS does not have the proper statutory powers to carry out the mandate. Let us give IRS the powers.

I stated in my prepared statement that the Internal Revenue Service, although it is the Nation's tax collector, is aware of its regulatory responsibilities in the field of employee plans and in the field of exempt organizations. It does not wear green eyeshades in the exercise of these responsibilities.

Given the flexible powers that your bill provides, the IRS would be in a far better position to protect the rights of participants and beneficiaries under pension plans in a way that does not impose such paperwork burdens on those who create or maintain plans as to impede the formation of new plans or require the demise of present plans.

Your bill eliminates much of the problems created by ERISA's section 103, more than six pages of specific paperwork requirements. It calls for submissions of massive detail. Your bill repeals this provision and instead puts the burden on the administering agency to require what is necessary, but only what is necessary, from the public, and require it in a way that is understandable to the public and useful to participants and their beneficiaries.

Thank you, Mr. Chairman.

Senator BENTSEN. Senator McIntyre?

Senator MCINTYRE. Thank you, Mr. Chairman.

I am delighted to see you here, Mr. Alexander, because, Mr. Chairman, Mr. Alexander was a very active member of the Paperwork Commission, and a very good one. He asked a lot of difficult, tough questions, embarrassing questions at times. We are sorry to see him leave. Did you participate closely with this December 3, 1976 report of the National Paperwork Commission on ERISA?

Mr. ALEXANDER. Yes, I did.

Senator McINTYRE. The bill being advanced by Senator Bentsen contains recommendation 1 and recommendation 2 of the Federal Paperwork Commission's suggestions and recommenadtions. The question that I raise in my own mind, why does it fail to include all the recommendations?

I thought I would ask you that. Did you agree with all the recommendations? For example, recommendation no. 3 on page 28—employers should be required to provide simplified statements of accrued benefits investing to employees in lieu of the complex financial statements presently required?

It may be that some of these recommendations do not properly belong in a statute per se, but should be very convincing and heavily endorsed report language. I would like to run through these quickly.

Did you agree with recommendation 3?

Mr. ALEXANDER. Yes. We agreed with all of the recommendations that related to IRS' authority and responsibility.

As to the recommendations that related to the Department of Labor, in my capacity as Internal Revenue Commissioner at that time, I noted those recommendations and thought that the approaches were sound. I have to hedge a little on whether we agreed fully on these or whether we had some reservations. I can tell you that we were strongly in favor of the elimination of section 103 and similar provisions in the statute that called for reporting detail, and the substitution of a general provision under which the agencies would then properly apply to make sure that they received what they needed when they needed it from the public, and that the participants and beneficiaries received what they needed to understand what their rights and obligations were.

I think recommendation 3 goes to this proposition. I think it is a sound recommendation.

Senator McINTYRE. Recommendation 4 directed the Commission of Internal Revenue to eliminate the requirement to file forms 5498 and 5499. Do you agree with that?

Mr. ALEXANDER. Yes.

Senator McINTYRE. Have regulations been issued to do that in the IRS, and making it unnecessary to discuss it further?

Mr. ALEXANDER. I think they have eliminated the duplicate filing of these forms. I think they are looking into eliminating one of the forms completely.

One of the forms is sent out to tell someone, not to tell the IRS, but instead to tell the particular participant about his or her participation and account, and people do need that sort of notice. They need to get it from the administrator of the particular plan.

Does IRS need it? The answer to that question is no, and I understand that IRS has done something about it.

Senator McINTYRE. How about the recommendation to eliminate form 5504 that appears on page 34, recommendation No. 5? Has that been carried out, to your knowledge?

Mr. ALEXANDER. I believe so.

Senator McINTYRE. Do you think it would be appropriate or inappropriate for report language to direct the IRS to eliminate these forms, or would that be inappropriate?

Mr. ALEXANDER. I think what the report language should do—I have already suggested what the bill should do—what the report language should do is call attention to the specific forms in question, whether they are necessary, and question whether they should be eliminated, if not eliminated already. I understand this particular one has been eliminated.

The problem of eliminating too many forms is that you find yourself with too little information. One has to strike a balance, as you know.

Senator McINTYRE. That would be delightful for a change. Too few forms. There seems to be an absolutely insatiable desire of IRS and everybody else in the bureaucratic world to ask too many questions, in my opinion—I realize some information, of course, is necessary.

Mr. ALEXANDER. Once in awhile it works the other way. Schedule D in the 1976 income tax return, I hope, was considerably better than schedule D on the prior income tax return.

That is one I had something to do with. I do not believe there were enough people with pre-1969 carryovers to clutter the form with questions that referred only to that particular type of situation. Those were eliminated, and you had a simpler schedule D.

With the enactment of the Tax Reduction and Simplification Act of 1977, we should have a simpler 1040A next year that will be materially helpful to the American public.

Senator McINTYRE. I congratulate you. Did you pick up a few more bucks for us that way?

Mr. ALEXANDER. I am not sure whether my successor is going to find that he picked up some more bucks. I tell you he is going to solve some headaches, not only headaches of his own, because he is a recipient of the public's complaints, but headaches of the public that had to cope with the 1976 Form 1040.

Senator McINTYRE. Mr. Alexander, I got here late. I just glanced through your statement.

Do you agree that Labor has enough interest in this to be part of a cooverseer of this ERISA plan, or do you think IRS can do it all by itself?

Mr. ALEXANDER. I think there is a place for both agencies in separate parts of the work. I think the problem is both agencies are now in almost all parts of the work. There is the problem. The problem is duplicative jurisdiction.

I think IRS knows how to cope and copes frequently in areas where other agencies may have restricted jurisdiction or specific responsibility. For example, IRS has long worked closely with the SEC. This situation may create some tension, some friction, of course. The nature of a bureaucracy is to wish for sole responsibility and sole authority.

The Government, however, does not work that way and cannot work that way. Our tax system intrudes on, affects and is affected by, just about everything we do, just about every activity that we conduct. That means that the IRS has long had the responsibility of working together with other agencies, in areas of proper interest to both IRS and another agency.

I think there is room here for both IRS and Labor—Labor was in this area before with the Welfare and Pension Plans Disclosure Act—Labor has responsibilities and perspectives different from IRS, responsibilities with respect to labor organizations and with respect to employees.

There is a role for both agencies, but duplication should be eliminated. I think 901 meets this issue in a sound way. One might suggest that prohibited transactions—for those not turning in fiduciary issues—should be left to the IRS rather than having section 4975 repealed; but the solution of S. 901 to the general problem is of such benefit to the public and the administrative agencies that I would not recommend that enactment founder on this issue.

If you try to do too much, I do not think you are going to do anything at all. Some have suggested that S. 901 does not meet all of the problems, therefore none of the problems should be met. I do not accept that.

Senator MCINTYRE. Let me ask this. Were you Commissioner of Internal Revenue at the time that ERISA was passed in the House and Senate?

Mr. ALEXANDER. Yes; I was.

Senator MCINTYRE. Is it true that the Internal Revenue had very little to do with the bill in its formation?

Mr. ALEXANDER. IRS did play a part. I was up at the Hill frequently working with the taxwriting staffs in connection with ERISA. I was quite concerned about tying two bills together with the duplicative jurisdiction that that entailed. I was hoping until the last minute, in the late summer of 1974, that that would not come about.

Senator MCINTYRE. Thank you, Mr. Chairman.

Senator BENTSEN. What we ran into in Congress is the same type of thing that you run into time and time again, where you have two committees involved and you have compromises that are not very satisfactory. That happened in this legislation.

You get cases cited—I can recall on specific case where they are talking about a situation of fiduciary malfeasance and it was a serious case, but that one serious case was used to put in restrictions that were extreme, and we hit all sorts of people all along the way. Just like an engineer designing a bridge—he wants to be sure that he is never questioned about the structure, so he spends something far beyond what is necessary.

That is what we have, in some instances, in ERISA. We had administration witnesses yesterday testifying in general support of the thrust of S. 901 and the objectives of S. 901, but talking about needing substantial amounts of time to arrive at their recommendations as to what should be done in the way of amendments and change to it. That concerned me very much.

I also know that we have had a great mass of people working on this, trying to work out the differences, for many, many months. I know under your administration that those people were there working. Most of those people are civil servants who are still there. They are in the IRS and they are in the Labor Department.

The changes really are at the top, in the policy people. So that this research has, in general, been done, and it has now reached the point where it is up to the decisionmakers and all of that detail, all that background, has been accomplished by the same people who are there now. Is that not in general correct?

Mr. ALEXANDER. Yes, sir. I think there has been plenty of time.

Senator BENTSEN. It is a matter of the new policymakers familiarizing themselves with a great deal of work that has been done.

Senator McIntyre?

Senator MCINTYRE. I do not want to go into the history of the bill, but what were the two committees, Finance——

Senator BENTSEN. And the Labor Committee.

Senator MCINTYRE. I have an impression you could not have done a worse job if you were directed by Beezlebub himself. We had oversight hearings in these two committees last year that were a horror story.

Mr. ALEXANDER. Senator Bentsen was doing his utmost to achieve two goals, one, to establish and protect rights, two, not to overregulate. BUT ERISA was a legislative compromise among four committees.

One of the possible facets in this problem is the right of oversight and the duty of oversight in an area that needs it, in an area that is very important to the Congress and very important to the public. I want to suggest that when I was in IRS we were accountable to many different committees in addition to the tax writing committees. An example is the Committee on Government Operations in the House—I think they had more hearings with respect to IRS activity or lack of activity than did the Ways and Means Committee.

Similarly, in the Senate we have testified before many committees. Straightening out the jurisdictional problem in the statute would, by no means, diminish the right or the obligation of committees to exercise effective oversight responsibility to make sure that the administrative agencies are doing what they should be doing.

Senator BENTSEN. Let me say to my distinguished friend from New Hampshire, because I was a part of that conference, I would say what you have before you now, S. 901, was much that was in the bill that came out of the Senate. I think it is far superior to what finally happened.

You have been in conference with the House. You have not always prevailed.

Senator MCINTYRE. We have tried.

Senator BENTSEN. I understand. So have I.

Senator MCINTYRE. Another example is OSHA—the Occupational Safety and Health Act. The Banking Committee on which I serve also has some bills that we are responsible for, like fair credit reporting.

I think Mr. Alexander has heard the stories all across the board and realizes that somehow we have to get ahold of this monster.

Senator BENTSEN. We must not neglect the good things that we have done when we put in realistic funding and vesting standards. We brought some reality to some pension plans that were a farce, in effect, almost a fraud, where pension beneficiaries thought they were going to have something when they retired and there really was not going to be anything. They thought they had security and it was the farthest thing from it.

Those things were accomplished. What we are talking about now is getting rid of some of this incredible redtape.

Thank you very much, Mr. Alexander.

Mr. ALEXANDER. Thank you, Mr. Chairman.

[The prepared statement of Mr. Alexander follows:]

STATEMENT OF DONALD C. ALEXANDER; OLWINE, CONNELLY, CHASE, O'DONNELL & WEYHER, NEW YORK AND WASHINGTON

I am pleased to testify in support of S. 901, the Pension Simplification Act of 1977.

As Commissioner of Internal Revenue from May 1973 through February 1977, a period beginning when the Employee Retirement Income Security Act (ERISA) was taking shape, and extending for 2½ years after its enactment, I became deeply concerned about problems of overlapping authority and responsibility. Little experience in the executive branch is necessary to teach an administrator that governmental processes, at best, work slowly. "At best" implies responsibility and authority in a single agency or department. Irrespective of the good intentions of those charged with responsibility for administering a law, assigning the same responsibility to more than one department or more than one agency results in a disproportionate increase in the time and trouble involved in getting something decided, announced and implemented.

So ERISA began its life in trouble—trouble because the Department of Labor and the Internal Revenue Service, with quite dissimilar experience, attitudes and objectives, were given much the same job to do. Until the final Congressional actions were taken in the late summer of 1974, I had hoped that jurisdiction to administer and enforce the new provisions of law intended to establish and safeguard employee retirement rights would be assigned to one agency or the other or divided in a sound way between Labor and the Internal Revenue Service. With limited exceptions, such was not the case. James Hutchinson, former Administrator of Labor's Pension and Welfare Benefit Programs, has aptly characterized the legislative scheme as "inherently unworkable."

We tried to make it work. Labor tried and the Service tried. It did not work well enough, however, to meet the needs of the public, the wishes of Congress, or what we wanted from ourselves. Although conditions have improved substantially, as Labor Secretary Marshall pointed out to the House Ways and Means Oversight Subcommittee on April 5, large backlogs have been built up and there have been long delays in implementation of key provisions.

Remedial actions should be taken in the longrange best interests of employees and employers, but these actions should not disregard accumulated experience in administering ERISA and pre-ERISA law. Nor should these actions impede the current efforts to cope with backlogs and to produce the meaningful guidance and actions so necessary at this time.

I believe that the sound way to proceed is to eliminate overlapping jurisdiction by allocating responsibilities between the Internal Revenue Service and Labor. S. 901 would make this assignment of responsibilities. S. 901 squarely meets the issue of duplicate jurisdiction and resolves it in a way designed to be sound for the future and sensible for the present.

The Service would be given sole responsibility over the areas of vesting, funding and participation. For well over thirty years the Service has been dealing with these problems, and it has the experience, the staff and the perspective necessary to resolve them in the best interests of the employees and employers. In fulfilling its role in this area, the Service does not wear green eye shades or arm garters. Its purpose is to safeguard rights, not to collect taxes.

What the Service needs, however, is additional remedies like those assigned to the Department of Labor under ERISA. Although the Service has used its enforcement tool, denial of exemption, with considerable skill so as to protect rights rather than destroy them, the Service needs the specific power to require the granting or restoration of rights. S. 901 recognizes this need.

Labor, which has recently handled some difficult issues of fiduciary responsibility well, would be given sole jurisdiction by S. 901 in this important area.

The Service would be no longer involved with prohibited transactions as such. I believe that Labor now has both the staff and the perspective necessary to fulfill these responsibilities. On the other hand, the Service is equipped to perform this work if it is perceived as an integral part of the whole; and in any event, the Service would still be concerned with the basic question whether the plan was for the execlusive benefit of empolyees or their beneficiaries.

Some have proposed that the entire regulatory responsibility be placed in the Labor Department and some have proposed that it be placed in a new agency located, perhaps, outside of both Labor and Treasury. While reasonable people can differ, I do not believe either of these solutions is as desirable as the one contained in S. 901.

In the first place, the provisions governing qualification of retirement plans have long been in the Internal Revenue Code and the Code affords a very large tax stimulus—in the form of unprecedented tax benefits—to the creation and maintenance of such plans. Under our present system of income taxation it is not feasible to separate retirement plans from the income tax laws largely responsible for the creation of many, if not most, such plans. Would Labor or a new agency take over responsibilities with respect to H.R. 10 Plans for the self-employed? What about Individual Retirement Accounts? Tax-sheltered Annuities?

Second, the Internal Revenue Service has more than thirty years of experience and has a large and knowledgeable staff both in Washington and in field offices, to administer these provisions of law. If Labor were to take over the Service's responsibilities, it would have to develop or take over the staff capable of carrying out these responsibilities. This is not an easy task, nor one promptly concluded.

The alternative of a new agency is even less desirable, in my judgment. While in theory this should remove problems of overlapping jurisdiction, in practice our present system of retirement planning depends upon the tax laws and the tax status of such plans. The Service would continue to have audit responsibilities, and proposing that the Service rely on the certification of another agency as to qualification may be more of a theoretical than a practical solution. Would the new agency attempt to decide the reasonableness of compensation? Furthermore, the problems and backlogs of the present would be greatly increased by the dislocation and delays attendant to the transfer of people from one agency to another, the bureaucratic jockeying for a position in the new agency, and the other human and institutional delays which attend the start of a new governmental organization. It isn't worth it. Postponing the effective date of any such transfer recognizes the problem but doesn't solve it.

Eliminating duplicative administration should remove much of the remaining paperwork problems created by the present dual administration. Amendments of the statute are required, however, and S. 901 takes a long step in the right direction by repealing some of the present detailed statutory reporting requirements. The statute should contain general directions calling for the reports needed to administer it properly, and the agency administering this statute should then require what is needed, but only what is needed, from the public. In deciding what is required, the administering agency should recognize that the primary needs are those of participants and beneficiaries to have the information sufficient to advise them of their interests and their rights.

As to Section 7 of S. 901, I am aware of the concerns ana frustrations of those who have not received answers to long-asked questions, but I wonder whether imposing a time clock (and a short one) is the best way to resolve this problem. While this approach finds precedent in ERISA (IR Code Section 7476), the views of present Service officials on this issue should be given great weight.

I will be glad to try to answer any questions you may have.

Senator BENTSEN. Our second witness is William Chadwick, former Administrator of Pension and Welfare Benefit Programs, Department of Labor.

We are delighted to have you here. You are from California and came with short notice so that we could have the benefit and expertise of a former Labor Department official. I know you had a very difficult task administering ERISA with the problems of dual jurisdiction and some of the excessive reporting, part of it mandated by statute.

STATEMENT OF WILLIAM J. CHADWICK, ESQ., PAUL, HASTINGS, JANOFSKY & WALKER, LOS ANGELES, CALIF.; FORMER ADMINTRATOR OF PENSION AND WELFARE BENEFIT PROGRAMS, DEPARTMENT OF LABOR

Mr. CHADWICK. As Don Alexander mentioned, prior to joining the Labor Department I was with the Treasury Department in the Office of Tax Legislative Counsel. In that capacity, I attended the sessions of the Committee of Conference on ERISA and reluctantly admit, at this point, that I participated in the sessions to draft the statute. I know some of the problems, many of the problems, and they have been as a result of the statutory language.

I sincerely appreciate your invitation to testify today. My testimony is presented as a public witness called by the subcommittee. The opinions that I express are my own, and I do not have any clients or client-interest in mind.

My testimony this morning will depart somewhat from the written testimony you have before you. I sincerely hope that does not cause you any inconvenience.

Yesterday's session, which I attended, compels me to cover some additional points.

I would like to begin my testimony this morning by focusing on the significance of the matter before this subcommittee—a matter which, in my opinion, is of much greater significance than ERISA itself. My focus today will be macro not micro in nature. Too often we tend to concern ourselves with particular and not general problems. As a result, we sometimes tend to lose sight of where we are going.

I would then like to suggest reasons for a more comprehensive solution to what I view a pending crisis in multiagency regulation of the employee benefit plan complex. I use that term, "employed benefit plan complex" to denote and include the entities regulated under the employee benefit laws, plans, plan sponsors, asset managers, service providers and, of course, the participants and beneficiaries.

While I do not want to overdramatize the current situation, I do want to emphasize the base and range of the problem, a problem which, in my opinion, goes to the fiber of the social and economic systems in this country. I would like to start off with a few facts and figures.

There are currently over 1.6 million private pension and health and welfare plans in this country and a countless number of plans maintained by Federal, State, and local governmental entities. Private plans provide benefits to approximately 35 million American workers, and the public plans provide similar benefits to approximately 16 million American workers.

This total of 51 million workers does not include the number of workers covered by old age, survivors and disability insurance—that is, social security. Some 147 million persons had social security earnings credits at the end of 1975. Of these, 123 million had been in the social security program long enough to qualify for payments at retirement.

These figures mean that one-half of all workers in commerce and industry in this country and close to three-fourths of all Government civilian personnel are covered by plans other than social security. The addition of those persons covered by social security increases the persons effected considerably. These figures reflect a dramatic increase in the number of persons covered by plans in 1940. I think it is fair to assume that these numbers will increase.

It should be clear, therefore, that the regulation of employee benefits has had, and will continue to have, significant impact on the labor market in this country.

These plans, according to the most recent figures released by the Securities and Exchange Commission, hold assets in excess of $445 billion dollars. These asset holdings represent one of the largest pools of capital in this country.

It should be equally clear, therefore, that the regulation of employee benefits has had, and will continue to have, a significant impact on the capital markets in this country.

These numbers are staggering and should lead us to the conclusion that employee benefits should be treated as a matter of priority. Unfortunately, employee benefits have not been treated as a matter of priority. Rather, employee benefits have been considered on an ad hoc basis by both the legislative and executive branches. As a result, we have no Federal policy consistently applied.

If you look at it historically, the regulation of employees benefits dates back to the Tariff Act of 1913. The proliferation of laws, however, did not really begin until the 1930's. At that time, the increases in social needs that resulted from the forces of industrialization operating upon the super-annuated worker culminated in the enactment of the Social Security Act. The Social Security Act itself increased security consciousness.

Yet the Social Security Act, and the benefits provided thereunder, only provided a subsistence level of living, while public policy seemed to demand assurance of greater continuity in the worker's standard of living and other benefits.

Congress has attempted to implement this policy largely through revenue-related incentives. For example, tax benefits, and the concomitant Federal regulation, were provided in the Revenue Act of 1942, the Internal Revenue Code of 1954, the Self-Employed Individuals Tax Retirement Act of 1962, and the Tax Reform Acts of 1969 and 1976. These incentives, for example the net exclusion of contributions and earings, cost the Federal Government $6.45 billion in fiscal 1976.

Tax-economic laws, however, were not the only—or necessarily the most significant—legislative enactments to affect the employee benefit plan complex. The various components of the plan complex were effected by most of the labor legislation of the last four decades, including the National Labor Relations Act, the Labor Management Relations Act or Taft Hartley, the Welfare and Pension Plans Disclosure Act, and the Labor Management Reporting and Disclosure Act of 1959 or Landrum-Griffin.

These two sets of laws were designed for different purposes and reflect different perspectives—tax-economic and labor management relations. Today, there are no less than 40 Federal laws of this nature relating to employee benefits and there are at least 20 Federal departments and agencies assigned with responsibility for administering and enforcing these laws.

Obviously, the proliferation of laws and the burgeoning bureaucracy designed to implement them has lead to an incredibly complex regulatory network—a maze of regulation which is beyond the comprehension of most of the people in this country. More importantly, this maze has fostered the development of inconsistent policy and legal pronouncements relating to those laws. Since there is no Federal policy consistently applied, we have no direction.

It is clear that the present system for administering and enforcing the 40 laws relating to employee benefits is not working. The administration and enforcement of ERISA—the most comprehensive law relating to employee benefits—is neither efficient nor effective.

Increased costs has been one of the results. I do not think you can justify costs when you are wasting money through duplication of effort and other such things.

Let us look at ERISA just briefly. You have heard testimony yesterday and some preceding me this morning. I would like to focus on a few of the problems.

It is clear that the reporting and disclosure mechanism that is inherent in ERISA and has been put in place under ERISA results in duplication of plan descriptive and financial material.

I think we have seen considerable delay in the implementation in the minimum participation, vesting, benefit accrual and funding standards.

There has been a lot of confusion from the interpretation of the exclusive purpose rule in section 404 of ERISA and the exclusive benefit rule in the Internal Revenue Code, section 401(a).

I also think that the procedure for granting administrative exemptions from the sweeping prohibited transaction provisions contained in ERISA and the Internal Revenue Code has caused problems, the delay.

In my opinion, the Department of Labor, the Department of Treasury, including the Internal Revenue Service, and the Pension Benefit Guarantee Corporation have made very genuine efforts to make the statute work. In my opinion, the statutory scheme, which is a result of compromise, is inherently unworkable.

As I stated at the beginning of my testimony, the matter before this subcommittee and the selected committee is of greater significance than the ERISA itself. I urge you not to lose sight of the problems created by other laws. The best known example is evidenced by the case of *Daniel* v. *International Brotherhood of Teamsters*, which case is currently on appeal to the Seventh Circuit.

In that case, the district court in Chicago held that an interest in an employee benefit plan was a security and, by virtue of the employment relationship, the employee gave value for the security. The result was the sale of the security, which gave rise to the application of the antifraud provisions under section 10(b) of the Securities and Exchange Act of 1934.

This case, or oral argument in this case, was heard on April 4. The Securities and Exchange Commission argued that the lower court decision should be affirmed. In other words, the Securities and

Exchange Commission argued that an interest in the plan was a security and there, in fact, had been a sale.

Interestingly enough, the Labor Department also delivered oral argument. The Labor Department argued that an interest in the plan was not a security.

In my opinion, two Government agencies before the court of appeals, taking two different positions, makes the Government look absurd. *Daniel* is probably the best known decision——

Senator BENTSEN. I am going to ask you to summarize because we are going to have a problem as far as our time here. We have other witnesses.

Mr. CHADWICK. There are other examples; they are cited in my testimony. I think we should seriously question whether there is wisdom behind the uncertainty and expense of having different agencies taking different positions and having to go to court to get an issue resolved. That is an expense that many small employers in this country cannot bear.

I think that we need a more comprehensive solution than that embodied in S. 901. I feel that way for a number of reasons.

We have to solve, not only the immediate problems under ERISA that we all recognize, but also the problems we are starting to see under other laws. I think that if we just give IRS responsibility for participation, vesting, and funding and Labor the responsibility for fiduciary matters and prohibited transactions, we are only solving part of the problem.

More importantly, I am concerned with the way we have solved that part of the problem. These areas of concern, participation, and vesting of fiduciary responsibility, have both tax economic and labor-management aspects and considerations. Participation, vesting, and funding are not merely matters of tax-economic concern. Regulation in this area has a significant impact on the substantive rights of participants and beneficiaries. Similarly, fiduciary responsibility is not only an area of labor-management concern. You are talking about $445 billion in plan assets. Are you going to have the Labor-Management Services Administration in the Department of Labor interpret those provisions perhaps without the input of the Office of Capital Market Policy in Treasury and the Securities and Exchange Commission? That concerns me.

I would like to make a few closing comments on some of the fiduciary provisions of S. 285. I think that it is clear that ERISA has had a chilling effect on the acquisition and dispositon of securities by plans. Asset managers, bank trust departments, for example, insurance companies, mutual funds, other employee benefit plans, have reacted defensively to the specter of personal liability.

I think they have adopted overconservative investment policies. The principal reason, I think, is the failure to understand ERISA's fiduciary provisions.

ERISA's section 404 is largely a codification of the common law of trusts. However, that common law rule was modified by an explicit statement in the legislative history that interpretation of, for example, the prudent man rule should bear in mind the special nature and purpose of employee benefit plans.

That statement was put in the conference report to inject much-needed flexibility. This flexibility should accommodate modern portfolio theory and the agencies and the courts should recognize that. Modern portfolio theory focuses on the overall portfolio and not in any individual investment. You look at the portfolio in the aggregate.

Modern portfolio theory should accommodate the leeway rule that I fully support. We should not try and keep plans out of any particular investment. We look at the portfolio in the aggregate.

On the other hand, the concentration rule probably does not come in under ERISA. That result may very well have to be legislative. I would fully support that also.

At this time I would be happy to answer any questions you may have.

Senator BENTSEN. Senator Matsunaga?

Senator MATSUNAGA. I do not quite understand, in proposing that we look at the aggregate portfolio, are you saying that you are opposed to the proposal made in Senator Bentsen's bill that we would permit 2 percent to be invested in high-risk ventures?

Mr. CHADWICK. I would say that, inherent in the fiduciary responsibility provisions in ERISA, there is the flexibility to invest in both high-risk and low-risk debt and equity instruments. You are looking at the total portfolio.

I do not think that the prudent man rule, for example, contained in ERISA, precludes private placement offerings, writing covered calls, perhaps butterfly commodity straddles, things of that nature, which are generally high-risk vehicles. There is a balance.

You are looking at the reaction of a total portfolio to social, political, and economic events. The components of that portfolio will react in different ways. One political event, for example, may make certain portions of that portfolio increase in value while at the same time, decreasing the value of other securities.

Asset managers should be trying to construct the portfolio so that aggregate risk justifies the expected return, which would be the return which was necessary under the plan. The return that is necessary would depend on the nature, type, and size of the particular plan.

Senator MATSUNAGA. You are saying that the application of the prudent man rule to the aggregate portfolio would make it unnecessary to set aside a 2-percent high risk?

Mr. CHADWICK. Yes, but there is one if. The if is you have to get the courts and the administrative agencies to recognize the validity of what I refer to as modern portfolio theory, because I think modern portfolio theory would permit that result.

I am a little concerned about legislating the result. Let me tell you why.

If you start legislating something of this nature, I think you will come under increasing pressure to legislate that type of result in for covered calls or butterfly commodities spreads. Therefore, you would have exceptions to the statutory scheme.

Investment managers will turn to those exceptions to the maximum extent possible and take a very conservative approach with regard to the core of the portfolio, perhaps an index fund.

I do not think that, in the long run, that that is the type of result we want to see. On the other hand, it is pretty clear that the agencies and the courts are going to have to speak so that people know and understand these rules and we thaw the chilling effect that resulted from ERISA.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Senator BENTSEN. Mr. Chadwick, I would certainly agree with you that the way they ought to look at their portfolio is in the aggregate. I believe that.

But there are an awful lot of people who are scared to death that that is not the way that the courts would look at it, so the safest thing for them to do is to invest in IBM or General Motors. If that blue-chip investment goes down the tube, nobody is going to accuse them of making a bad judgment, but if they invest in Widget Co., that nobody ever heard of except in a regional area, the judge is going to have the benefit of hindsight and use it on them, and that is what worries a lot of people.

Sixty-four percent of the pension trustees surveyed by the International Foundation of Employee Benefit Plans in 1976 reported that as a result of the 1974 Pension Reform Act they were unwilling to invest in anything except blue chip type of investments.

What we are trying to do with the leeway clause is to correct an unintended side effect.

In response to a questionnaire, the executive vice president of the Chemical Bank told the subcommittee that a number of factors, including the enactment of ERISA, have caused them to substantially reduce their investment of pension funds into venture capital situations. Another banker says, "we think it is no longer appropriate to make venture capital commitments in retirement funds." That is what we run into, as a practical thing. What we are talking about with the 2-percent leeway clause, is what we have seen in a great many State insurance laws.

Many States permit life insurance companies to invest a small portion of their assets in companies that would not otherwise qualify as acceptable investments. That is a source of venture capital. It is also a source of possible large potential profits for the pension beneficiary.

At one point, Xerox and many other companies were a small venture profit outfit. This kind of thing we think will be helpful.

I appreciate your testimony. I particularly appreciate your coming such a distance.

Mr. CHADWICK. Thank you. It was a pleasure to be here.

[The prepared statement of Mr. Chadwick follows:]

TESTIMONY OF WILLIAM J. CHADWICK, ESQ., PAUL, HASTINGS, JANOFSKY & WALKER, LOS ANGELES, CALIF.

Mr. Chairman, my name is William Chadwick and I am with the law firm of Paul, Hastings, Janofsky & Walker in Los Angeles, California. Prior to returning to the private practice of law in March of this year, I played a role in the administration of the Employee Retirement Income Security Act of 1974 (ERISA) on behalf of the Labor Department, as the Administrator of Pension and Welfare Benefit Programs (and, before that, as the Special Assistant to the Administrator) and on behalf of the Treasury Department, as an attorney adviser for tax policy in the office of the Tax Legislative Council. I attended the sessions of the Committee of Conference on ERISA and participated in the sessions held to draft the law.

I sincerely appreciate your invitation to testify today on S. 901, the Pension Simplication Act of 1977. My testimony is presented as a public witness called by the Subcommittee. The opinions that I express on my own and do not purport to represent the views of any client.

I would like to begin my testimony today by focusing on the significance of the matter before this subcommittee—a matter of greater significance than ERISA itself. I would then like to suggest reasons for a more comprehensive solution to the pending crisis caused by multi-agency regulation of the employee benefit plan complex. While I do not want to overdramatize the current situation, I do want to emphasize the base and range of the problem—a problem which, in my opinion, goes to the fibre of the socio-economic and political systems in this country.

There are currently over 1.6 million private pension and health and welfare plans in this country and a countless number of plans maintained by federal, state and local governmental entities. Private plans provide benefits to approximately 35 million American workers, and the public plans provide similar benefits to approximately 16 million American workers. This total of 51 million workers does not include the number of workers covered by Old Age, Survivors and Disability Insurance i.e., Social Security). Some 147 million persons had social security earnings credits at the end of 1975. Of these, 123 million had been in the social security program long enough to qualify the payments at retirement.

These figures mean that one-half of all workers in commerce and industry in this country and close to three-fourths of all government civilian personnel are covered by plans other than Social Security. The addition of those persons covered by Social Security increases the persons effected considerably. These figures reflect a dramatic increase in the number of persons covered by plans in 1940. I think it is fair to assume that these numbers will increase.

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It should be equally clear, therefore, that the regulation of employee benefits has had, and will continue to have, a significant impact on the capital markets in this country.

These numbers are staggering and should lead us to the conclusion that employee benefits should be treated as a matter of priority. Employee benefits, have not been treated as a matter of priority. Rather employee benefits have been considered on an ad hoc basis by both the legislative and executive branches. As a result, we have no federal policy consistently applied.

Regulation of the employee benefit plan complex can be traced back to the Tariff Act of 1913. The proliferation of laws, however, did not begin until the 1930's. At that time, the increases in social needs that resulted from the forces of industrialization operating upon the superannuated worker culminated in the enactment of the Social Security Act. The Social Security Act itself increased security consciousness. Yet the Social Security Act, and the benefits provided thereunder, only provided a subsistance level of living, while public policy seemed to demand assurance of greater continuity in the worker's standard of living and other benefits.

Congress has attempted to implement this policy largely through revenue-related incentives. For example, tax benefits, and the concomitant federal regulation were provided in the Revenue Act of 1942, the Internal Revenue Code of 1954, the Self-Employed Individuals Tax Retirement Act of 1962, and the Tax Reform Acts of 1969 and 1976. These incentives, for example the net exclusion of contributions and earnings, cost the Federal government 6.45 billion dollars in fiscal 1976.

Tax-economic laws, however, were not the only (or necessarily the most significant) legislative enactments to affect the employee benefit plan complex. The various components of the plan complex were effected by most of the labor legislation of the last four decades, including the National Labor Relations Act, the Labor Management Relations Act or Taft Hartley, the Welfare and Pension Plans Disclosure Act, and the Labor Management Reporting and Disclosure Act of 1959 or Landrum-Griffin.

These two sets of laws were designed for different purposes and reflect a different perspectives-tax-economic and labor management relations. Today, there are no less than 40 federal laws of this nature relating to employee benefits and there are at least 20 federal departments and agencies assigned with responsibility for administering and enforcing these laws.

Obviously, the proliferation of laws and the burgeoning bureaucracy designed to implement them has lead to an incredibly complex regulatory network—a maze of regulation which is beyond the comprehension of most of the people in this country. More importantly, this maze has fostered the development of inconsistent policy and legal pronouncements relating to those laws. Since there is no Federal policy consistently applied. We have no direction. It is clear that the present system for administering and enforcing the 40 laws relating to employee benefits is not working. The administration and enforcement of ERISA—the most comprehensive law relating to employee benefits—is neither efficient nor effective.

The reporting and disclosure scheme that has developed under ERISA results in the duplication of descriptive and financial information.

There has been considerable delay in the development of the regulations relating to participation, vesting, benefit accrua land funding.

Confusion has resulted from to interpretation of the exclusive purpose rule in ERISA and the exclusive benefit rule in the Internal Revenue Code.

The procedure for granting administrative exemptions from the sweeping prohibited transaction provisions contained in ERISA and the code has been, and will continue to be, plagued with problems resulting in delay.

In my opinion, the Department of Labor, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation have made genuine efforts to make the statute work. The statutory scheme, however, is inherently unworkable.

As I stated at the beginning of my testimony the matter before this subcommittee is of greater significance than ERISA itself. I urge you not to lose sight of the problems created by the administration and enforcement of the other laws by the other agencies.

The best known problem is evidenced by the case of *Daniel v. International Brotherhood of Teamsters*, which is currently on appeal to the Seventh Circuit. In this case, the court held that a participant's interest in a noncontributory pension plan constituted a security and that, by virtue of the employment relationship, the employee gave value for the security. The sale of the security gave rise to the application of the antifraud provisions of the Securities Exchange Act of 1934. On appeal, the Securities and Exchange Commission argued in favor of the decision while the Labor Department argued against it. In my opinion, the different positions taken by the SEC and the Labor Department are absurd. While *Daniel v. Teamsters*, is the best known example, there are others. One involves sex differentials in welfare plans. In the case of *G. E. v. Gilbert*, the Supreme Court recently held that the exclusion of pregnancy-related disabilities from a disability plan does not result in unlawful sex discrimination in the absence of a showing that the selection of an included risk creates a gender based discriminatory effect or the exclusion is used as a pretext for discriminating against women. Interestingly enough, this decision is contrary to the guidelines published by the EEOC under Title VII of the Civil Rights Act of 1964, as amended by the Equal Employment Opportunity Act of 1972; however, that decision was in accord with the Labor Department Guidelines published by the Office of Federal Contract Compliance under the Equal Pay Act.

Another example involves the controversy relating to whether equal contributions or equal benefits are required for both sexes under pension plans. The Labor Department's Wage and Hour Division and the OFCC, the Justice Department's Office of Civil Rights and the Treasury Department are involved in this problem. Again, the courts will have to decide.

I think we should all question whether the interest of Americans are furthered by the uncertainty and expense connected with the appeals to the Supreme Court. These inconsistent policy and legal pronouncements by different departments and agencies make compliance with the laws by entities maintaining plans both difficult and costly. Congress must take some steps to put a more functional mechanism in place.

I believe that we need a more comprehensive solution than that embodied in S. 901. We must not only solve the most immediate and pressing problems under ERISA, but the problems caused by the administration and enforcement of other laws by other agencies. If we place responsibility for participation, vesting and funding with the Internal Revenue Service and responsibility for fiduciary responsibility and prohibited transactions with the Labor Department we will only be solving part of the problem.

I do not even believe that this solution to the most acute part of the problem is necessarily the best solution. These areas of concern have both tax-economic and labor management aspects and considerations. Participation, vesting, and funding are not merely matters of tax economic concern. Regulation in this area has a significant impact on the substantive rights of the 40 million workers covered by plans. Similarly, fiduciary responsibility and prohibited transactions are not merely matters of labor-management concern. The regulation of 445 billion dollars in plan assets has very significant economic, particularly capital formation, implications. I think we all have to search for a viable way to coordinate and consolidate these functions.

Senator BENTSEN. Mr. Richard H. Fay is our next witness.

STATEMENT OF RICHARD H. FAY, ESQ., WASHINGTON, D.C.

Mr. FAY. Good morning, Senators.

Presently I am in the private practice of law with a law firm, but my testimony is as a private citizen called by the committee. However, my firm provides legal services for many employee benefit plans and therefore I believe my experience in this area might be of interest.

I will summarize my statement. First, the record is clear that the present administration framework for ERISA is unworkable. Two, it seems to me that S. 901 is a commendable effort to provide some clarity in the administration of ERISA and I would support if for the reasons stated in my testimony.

However, for the reasons stated in more detail in my testimony—the broad scope of the area, the large number of Federal laws, the conflicting policy of the Federal Government—I believe that a single, independent agency offers the best long-term solution to the administration of ERVA. I emphasize long term.

This, of course, would mean that the regulation of tax-qualified plans would be outside the IRS. I do not believe that this approach is unprecedented. I believe that it is workable.

It also means to have the necessary experts, there would have to be a transfer of IRS personnel. I think that this can be done. Such a transfer does not mean that there would never be any legitimate IRS concern and involvement with these plans. A tax area that comes to mind is section 162. All of life is a seamless web, and we try to organize our lives in manageable categories. It seems to me that an independent agency offers that hope of a manageable category.

Starting on page 7 of my statement, I outline reasons, that are convincing for me, why I believe that the independent agency approach is the best approach, and on page 9 I offer some caveats to such an approach.

One, is that the present administration of ERISA has not been without merit, a lot of the difficulty of administrating ERISA stems from the legislation itself. Second, any such approach is a long-term approach which cannot be done overnight. One of the great advantages of S. 901 is that it improves the present system, without disrupting it.

I would like to discuss a subject also contained in S. 901 which has not been mentioned today, and that is the declaratory judgment procedure. As I understood it, when Congress was considering ERISA, there was concern with the inability of taxpayers to challenge what they thought were inapproprite and wronk determinations by the IRS. Accordingly when Congress enacted ERISA, they provided a declaratory judgment procedure.

This procedure has been expanded in S. 901, and I think rightly so because nobody can accuse the Tax Court of being promiscuous with their favors. In fact, in only one case have the Tax Court found that they can exercise the declaratory judgment procedure.

In my testimony I list the several cases where the Tax Court ruled it cannot use this procedure. The most disturbing of these cases is the *Prince Corporation* case where they held that, even though 270 days had expired, the declaratory judgment procedure was still not proper.

Therefore, I recommend and support the provisions contained in Senator Bentsen's bill to strengthen the declaratory judgment procedure. On page 12 of my testimony, I list other ways the declaratory judgment procedure can be improved. Specifically, the Tax Court should have jurisdiction over determinations, not only of the IRS, but also of DOL in areas affecting employee benefits plans, there should be clarification of the requirement of exhaustion of administrative remedies, both in IRS and DOL.

Finally, declaratory judgment procedure should be extended, not only to plans subject to the amendments of ERISA, but to other plans.

As I promised, I have summarized my statement, Thank you very much.

Senator BENTSEN. Thank you.

Senator Matsunaga?

Senator MATSUNAGA. Thank you very much, Mr. Chairman.

Were you here yesterday, listening to the testimony of the IRS and Labor Department people?

Mr. FAY. I was not here, but it has been reported to me. I think I could discuss their positions.

Senator MATSUNAGA. They indicated they are now in the process of coordinating their efforts, that they will in fact get together and come out with a plan which will be such that it will not be divided obviously into jurisdictional disputes, et cetera. Do you think this can be done?

Mr. FAY. Did they promise to come back with a legislative proposal in 60 days, or something like that?

Senator MATSUNAGA. We tried to get that commitment and could not.

Mr. FAY. I think they will cooperate to the extent that they feel they can. I would not have much hope.

It seem to me if you want the approach of S. 901, it has to be done either by Executive order or by legislation. I think the agencies are constrained by the present legislation.

Senator MATSUNAGA. The fear expressed is that we already have two bureaucratic agencies involved. The creation of a third, independent whatever you may call it would mean a third bureaucracy involved.

Mr. FAY. Of course, that is the secondary issue. The first issue raised was the clearer allocation of functions between the two existing agencies, and that is a narrow way of looking at the problem. We have at least the Pension Benefit Guaranty Corporation involved in a major way.

I was addressing the first question, that is, I believe in order to obtain a clearer delineation of ERISA functions, an Executive order or legislation will be necessary. It does not seem to me to be something the agencies can do.

On the second question, that is, will a separate independent agency result in an increased bureaucracy, certainly it can go either way. I believe another agency would not, but would necessitate the transferral of present personnel to this agency. The present arrangement results in unavoidable duplication and increased bureaucracy, which is not necessary.

The strange thing, is that although you have two groups of people and two agencies doing the same things, in many ways their knowledge and oversight is limited to their jurisdiction, so you have only partial experts. An independent agency would not increase bureaucracy, but in fact provide people with a much broader view that they can have now.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Senator BENTSEN. Mr. Fay, I appreciate very much having you here. I know how much you worked on ERISA and your knowledge of it and your experience and background, and you also fully appreciate the fact that it accomplished many fine things although it has frustrated us with overregulation.

Mr. FAY. I wish to concur with your statement; the achievements of ERISA do not receive the same kind of publicity. A lot of people are receiving benefits they did not receive before. There are a lot of former abuses that will not now occur. It is like the silence in the forest. It does not attract attention. What we are really doing now is housekeeping.

Senator BENTSEN. As I understand it, we have not had many complaints from employees whose benefits are protected.

Thank you very much.

Mr. FAY. Thank you, sir.

[The prepared statment of Mr. Fay follows:]

TESTIMONY OF RICHARD H. FAY

Mr. Chairman and distinguished members of the committee, I wish to thank you for this opportunity to testify at these oversight hearings on the administration of the Employee Retirement Income Security Act of 1974 (ERISA). Although I am practicing law with the law firm of Reed Smith Shaw & McClay, I am testifying today as a private citizen. My testimony this morning is being presented as a public witness called by the Committee. The opinions expressed are my own, and do not purport to represent the views of any client or group. Reed Smith Shaw & McClay, however, is responsible for providing legal services for many employee benefit plans, and, therefore, I believe that my experience in this area might be of interest and value to this Committee.

Perhaps the most telling comment one can make about ERISA is that almost three years after its enactment, we are still trying to determine how to administer it. Last year, in joint hearings by the Senate Finance Committee and the Senate Select Committee on Small Business, an ample legislative record was developed here and elsewhere to demonstrate that the present administrative framework is duplicative, costly and fundamentally unworkable. As James Hutchenson stated within a week of his resignation as the first administrator of Pension and Welfare Benefit Programs at the Department of Labor (DOL):

". . . The single most pressing issue which must be addressed if ERISA is to work is the concept of multi-agency jurisdiction. . . ."

Senator Bentsen's bill, S. 901, which would provide a clearer delineation of the administrative duties between Internal Revenue Service (IRS) and DOL, is a commendable effort to clarify the administration of ERISA and would certainly be an improvement over the present chaotic and costly system. S. 901, while continuing a major role in employee benefit regulation for both IRS and DOL, would give to IRS exclusive jurisdiction over participation, vesting and funding standards and to DOL exclusive jurisdiction over fiduciary responsibility and prohibited transactions standards. S. 901 would greatly reduce the statutory reporting requirements of ERISA. S. 901 would eliminate much of the cost and duplication presently required by ERISA. Also, since it leaves a great deal of existing administrative structure in place, it would be the least disruptive of the various legislative proposals that have been made for dealing with the present administrative quagmire. Passage of S. 901 would improve the administration of ERISA.

Although I believe S. 901 is an improvement over the present system, I would like to suggest and discuss an alternative solution—a solution that would represent, for the first time, a consistent federal policy regarding employee benefit plans rather than the present ad hoc approach, an approach that would recognize the diversity, growth and importance of employee benefit plans. Employee benefit plans has become over the years an increasingly important and complex field, but its development is seriously threatened by a lack of a comprehensive federal policy.

The question of the most sensible administration of employee benefit plans should not be viewed as a jurisdictional battle between one legislative committee or another, or a tug-of-war between one agency and another. Employee benefit plans have grown beyond traditional areas of government regulations and now present a host of national policy issues.

In 1940, private pension plans provided benefits to only about 4 million workers. Today, private pension plans provide benefits to approximately 35 million workers, with public plans providing similar benefits to approximately 16 million American workers. Almost one-half of all workers in private industry are covered by private pension plans. Currently, there are over 1.6 million private pension and health and welfare plans in this country and countless numbers of plans maintained by federal, state and local entities. As the private pension area has grown, the government's response has been fragmentary and disorganized. William Chadwick, a former administrator for Pension and Welfare Benefit Programs, estimates that there are at least 40 federal laws relating to employee benefits and at least 20 departments and agencies administering and enforcing these laws. The proliferation of these laws and growing bureaucracy has led to a maze of regulations—a maze which few, if any, can traverse with success—a maze where even the federal government loses its way.

There are countless examples where government policies regarding employee benefit plans are not only confused, but contradictory. Consider, for example, the different positions taken by the Securities and Exchange Commission, the Treasury and Labor Departments in *Daniel* v. *International Brotherhood of Teamsters*, which is currently on appeal to the Seventh Circuit. The Department of Justice advised the Court that it was withdrawing and, therefore, DOL's view would not represent the views of the United States. DOL and the Securities and Exchange Commission each appeared before the Court and argued for different interpretations of the application of securities law to an employee's interest in the collective bargaining pension plan.

Another example is *G.E.* v. *Gilbert*, in which the Supreme Court held that under the circumstances of the case the exclusion of pregnancy-related disabilities from a disability plan does not result in unlawful sex discrimination. Once again the government is of two minds on this issue. The Supreme Court's decision was contrary to the guidelines published by EEOC under Title VII of the Civil Rights Act of 1964, but was in accordance with DOL guidelines published by the Office of Federal Contract Compliance under the Equal Pay Act.

Another example is the proper allocations of plan assets upon termination of a defined benefit plan. Title IV of ERISA requires that assets be allocated on the basis of prescribed priorities. This mandatory allocation determines, among other things, how much of a participant's benefit must be provided from Pension Benefit Guaranty Corporation (PBGC) funds, as opposed to the plan's own funds, a safeguard to protect the financial integrity of PBGC. The anti-discrimination requirements of IRS, however, also call for an examination of the manner in which assets are allocated at the termination of a plan. Recently the IRS announced that, even though a plan termination has previously received prior approval from IRS, an allocation of the assets of the plan in accordance with requirements of PBGC may result in a retroactive disallowance of IRS prior qualification necessitating a further resubmission to IRS.

Just imagine the difficulty of pension consultants, lawyers and others attempting to advise employers on what to do. Much too often, the advice that you have to give your client is that while certain things may be required by one agency, a different or contrary result may be required by another federal agency. In this area, the government surely speaks with a forked tongue. As litigation increases, the problem will become much more intense. ERISA aids and abets litigation. This litigation will become hopelessly confused and unproductive if the federal government continues to have contradictory policies as to what are the rights of participants of employee benefit plans.

It would seem time for Congress to consider a solution as broad as the problem—an approach as courageous as it is comprehensive. I believe that the creation of a single, independent agency to bring this multi-faceted area into one jurisdiction is a desirable and administratively possible solution. Such an approach of course, would require the regulation of tax-qualified plans to a large extent outside the IRS. It should be clearly understood that there is nothing to prevent application of federal tax consequences to the activities in question. Precedents to this kind of approach can be found in various sections of the Internal Revenue Code (Code): for example, the section dealing with determinations by the Federal Communications Commission (Code, Section 1071), the Securities and Exchange Commission (Code, Section 1081), and the Federal Reserve Board (Code, Section 1011).

A new, separate, independent agency administering the employee benefit plans does not mean that IRS would never have a legitimate question about such plans. Not only the law, but life itself, is a seamless web, and there is always a nexus. What I am merely suggesting is the grouping of the primary responsibility for employee benefit plans in one agency. This does not means that some tax issues will not occasionally have an impact on these plans. For example, IRS questions about reasonable compensation under Section 162 come to mind. A separate, independent agency to administer employee benefit plans would not prevent the IRS from disallowing a deduction to an otherwise qualified plan if it determined that Section 162 has been violated.

Of course a shift of most of the administrative responsibilities to a single agency would require a shift, not only of the present functions of IRS, but also of a substantial number of IRS personnel. In this regard, I was interested in then Commissioner of Internal Revenue Alexander's comment at the July 11 meeting of the Advisory Council on Employee Welfare and Pension Benefit Programs to the Secretary of Labor that, in his opinion, a transfer of IRS personnel to an independent third party would not take long, and that "all of our employee plan divisions could be transferred and should be transferred immediately to that third agency." I must hasten to add, however, that it was Mr. Alexander's strong opinion that a separate agency is "unnecessary and undesirable."

Let me state why I believe that a separate agency is necessary and desirable.

(1) A separate, independent agency would reduce bureaucracy, not increase it. The present system of at least three major agencies with several subsidiary agencies regulating the same area results in tremendous duplication of governmental personnel working on the same matter. Each may have his own different and narrow perspective. but each, to a large extent, is learning the same area. What is developing in the government is partial experts. None is developing or asked to develop an over-all view and comprehensive understanding of the area.

(2) The United States Government would start to develop a single uniform voice and policy regarding employee benefit plans. Presently, with three major agencies and a host of other agencies administering the area, there is no consistent policy. Presently, only the President of the United Sates can resolve such questions as different interpretations of benefit accrual rules or the definition of party-in-interest, which is absurd.

(3) An independent agency, separate from DOL and the Department of the Treasury (Treasury) would be better able to deal with and balance the sometimes conflicting and competing interests of the labor and tax aspects of ERISA. As long as the administrative agency is part of either DOL or Treasury, there will always be pressure, however subtle, on the administrative agency to conform its view to those of the department of which it is part. The public interest would

best be served by an independent agency which is free to decide the objective merits of an issue without feeling undue pressure because of its part of a particular agency.

(4) An independent agency would much more easily deal with congressional committees than an administrative agency affiliated with an existing department. Both the tax and labor committees of the House and Senate would have the same and coequal jurisdiction over such an agency. Furthermore, congressional committee oversight function would be improved and expanded because each committee would have jurisdiction over the entire field.

(5) Finally, an independent agency offers the only hope for coordinating and consolidating the multitude of governmental laws and regulations affecting employee benefit plans.

While I believe that a separate, independent agency is the best long-term solution to the problem of administering ERISA, it will not solve all of the problems with ERISA. There are substantive problems with certain provisions of ERISA which can be solved only by legislation. Furthermore, any change in the administrative structure should not be viewed as or have the consequence of further delaying the administration of ERISA. A change in administration should be viewed as a long-term and comprehensive solution to meet our long-term needs.

DECLARATORY JUDGMENTS

One of the best provisions of S. 901 is the proposed modification of Code Section 7476 to provide for concurrent jurisdiction of the Court of Claims, the Federal District Courts and the Tax Court for declaratory judgment regarding the status of Section 401 qualified plans. In the declaratory judgment area, however, the problem is not multi-jurisdiction, but the failure of the Tax Court to assert appropriate jurisdiction. The Tax Court has taken an overly restrictive view of its jurisdiction under Section 7476 with the result that the purpose of that section is not being fulfilled. For example, in *Federal Land Bank Association of Ashville* v. *Commissioner*, the Tax Court held that it had no jurisdiction to render declaratory judgments with respect to plans involving pre-ERISA years.

In *Shepherd & Myers, Inc.* v. *Commissioner*, the Tax Court also decided that it had no jurisdiction to render declaratory judgments with respect to questions involving continued qualification of a plan unless the questions were occasioned by an amendment or termination. In *Prince Corporation* v. *Commissioner*, the Tax Court held that it had no jurisdiction to render a declaratory judgment with respect to a qualification of a plan, even though the 270 day period had expired since the application for determination was filed. The Tax Court held that despite expiration of the period, the taxpayer still had to establish that he had exhausted his administrative remedies.

The Tax Court's approach has effectively resulted in thwarting several moves by taxpayers to obtain the intended benefit of the declaratory judgment procedure. One reason the Tax Court has been able to do this is the lack of clarity in the administrative review procedure of IRS. It is not clear at what point the administrative process has been exhausted. This area has now been further complicated by the option provided in ERISA for DOL intervention, and the lack of any clear determination whether or not the employer must have exhausted all procedures through DOL before the employer may proceed under the declaratory judgment procedure. Absent such a clear determination, there is a question as to whether the Tax Court has jurisdiction prior to exhausting administrative procedures before DOL.

Thus, in addition to the narrow construction already taken by the Tax Court of its jurisdiction, there are other questions which have yet to be considered which, if the Tax Court is consistent with its narrow interpretation, will mean frustration of the taxpayer's attempt to get a clean answer. For example, suppose DOL issued regulations on hours of service which a taxpayer believes to be inappropriate in his case. The present IRS position is that they will not qualify a plan unless it adheres to DOL regulations. Furthermore, IRS will not listen to arguments regarding DOL regulations, stating that they are not in a position to determine the validity or invalidity of those regulations. If the taxpayer seeks to obtain a declaratory judgment on these regulations, it is to be anticipated that the IRS, in defense of its action, first will raise the issue of lack of jurisdiction in Tax Court, and secondly, will raise the issue of its inability to follow any course of action other than that which it has already done, because the key regulation has been legislatively determined to be under the jurisdiction of DOL.

Even though the Tax Court has been raised to statutory court rather than an administrative court, its juridiction must be gleaned from the jurisdictional authority specifically granted to it by Congress. In view of the already demonstrated reluctance of the Tax Court to take jurisdiction, it would seem that by a continued strict construction of its authority, the Tax Court could easily claim lack of jurisdiction where the basic determination is not one initiated by the IRS, but rather by DOL. The net effect is that the declaratory judgment procedure becomes a farce for the many highly sensitive areas such as hours of service, years of service, etc., which are to be defined and determined by DOL, not IRS.

To achieve Congress' original intent in providing for the declaratory judgment procedure under ERISA, I would recommend that it be amended to provide that:

(1) The Tax Court has jurisdiction over determinations not only of IRS, but also of DOL, in areas affecting employee benefit plans.

(2) Clarification aof the requirements of exhaustion of administrative remedies in both IRS and DOL. Perhaps one solution is to provide that the expiration of the 270-day period, without agency action and without mutual extension, would be conclusive evidence of the fact that the petitioner has exhausted all administrative remedies and therefore a declaratory judgment procedure is permissible.

(3) The declaratory judgment procedures should be available to pre-ERISA plans or a plan not required to comply with ERISA, such as a pension benefit plan for church employees.

In closing, I would like to state that my statement today is not meant to be a criticism of the many dedicated persons in the federal agencies who have tried to make ERISA work. To paraphrase Winston Churchill, if you but give them the tools, they will complete the task. Unfortunately, the administrative framework of ERISA which was recognized as an unhappy compromise is, in part, tarnishing a good law with a bad name. The administrative framework threatens to greatly reduce the effectiveness of ERISA. It is resulting in unnecessary and increasing costs, and thereby reducing benefits to the American worker.

Once again, I would like to thank the members of the Committee for allowing me to testify and to share my thoughts on these issues of vital importance to American workers and the American economy.

Senator BENTSEN. We now have a panel representing private venture capital organizations, and if they would come forward: David T. Morgenthaler, president, National Venture Capital Association of Ohio; Richard Hanschen, Dallas, Tex.; Stewart Greenfield, Darien, Conn.; and Reid Dennis, San Francisco, Calif.

STATEMENT OF DAVID T. MORGENTHALER, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION, CLEVELAND, OHIO

Mr. MORGENTHALER. Thank you very much for the opportunity to appear before you today. I am David T. Morgenthaler, senior partner of Morgenthaler Associates, a private investment firm specializing in venture capital. We currently provide capital and serve as very active directors for some 10 corporations, principally technology-oriented enterprises four of which are public companies today.

These range in size from startup companies to over $100 million a year in sales rates.

I have been involved in the business of starting, building, investing in, and managing small companies since helping to start a company right after World War II. Our concern today, and for which our panel is present, is the damage that is being done to smaller businesses and the jobs that are not being created as a result of the unintended side effects of some of the ERISA legislation.

We would like to enter into the record, without taking your time to discuss it, a paper of the National Venture Capital Association called

"Emerging Innovative Companies: An Endangered Species." We note in this paper that the smaller, innovative companies which create jobs at a very high rate—surprisingly, at a much higher rate than the larger corporations—are in fact not being formed nearly as rapidly as they were being formed a few years ago.

[The following was subsequently supplied for the record:]

EMERGING INNOVATION COMPANIES—AN ENDANGERED SPECIES

Unless some solution to the present shortage of capital for large and small companies alike can be found, America's productive resources will grow old and the productivity of its workers will decline. Should this happen, our standard of living will decline.

This paper has been prepared by the National Venture Capital Association. NVCA represents professional venture capital investors as well as the companies they back, and the association is particularly concerned by the significant drop in new companies being started and financed in this country.

The following analysis and recommendations were developed in order to emphasize the importance of the emerging innovative company and how to encourage more such firms to get started and financed.

IMPORTANCE OF EMERGING INNNOVATIVE COMPANIES TO THE ECONOMY

Emerging innovative companies play a far more important role in our economy than is generally understood. Through their innovations these companies offer new products and services which improve the quality of life in this country and keep our system competitive. Moreover, these companies provide disproportionately more new jobs per dollar of capital employed than do mature companies, thereby facilitating the reduction of unemployment. Finally, they provide a substantial amount of revenue to the U.S. Government through corporate income taxes, and their rate of increase in income tax provision is growing far faster than that of mature companies.

In order to flourish, innovative companies require:

The availability of capital to fund the formation of new small companies (arising from the implementation of new technology, new ideas, or from the spin-offs of products or services from larger corporations unwilling to devote resources to the ongoing development of such products or services). It is the successful new small company of today which becomes the important innovative company of tomorrow.

The availability of capital to finance the growth of successful innovative companies, themselves. These companies provide substantial new jobs, grow at a rate far faster than can be financed by internally generated cash flow, and, therefore, depend upon external capital.

A favorable market climate to encourage the investment of capital in higher risk small new and innovative companies vs. in lower risk equities of mature companies or in bonds.

Appropriate incentives to attract capable management away from the high salaries and long term security provided by mature companies and into the emerging innovative companies which cannot afford competitive salaries, lack security, and can only offer the opportunity of substantial rewards if successful.

The case for emerging innovative companies

Many products and services, unheard of a few years ago, which now benefit our daily lives, were developed, not by mature companies, but by small innovative businesses. Semiconductors, and more recently large scale integrated electronic circuitry, minicomputers, microprocessors, computer peripherals and the expanding services they perform, hand-held calculators, automatic editing typewriters, new lifesaving medical equipment, high fidelity recording equipment and many other products are but a few examples. Companies producing these products and services keep our system efficient by challenging older, established mature companies who do not innovate and improve. They keep America at the cutting edge technologically and help our foreign trade balance.

Successful small companies become the substantial innovative companies which have a major impact on new job creation and pay increasing revenues to the Federal Government in the form of income taxes. Recently the M.I.T. Development Foundation completed a study on sales and employment trends among selected young high technology companies, innovative companies and mature companies. The companies encompassed in the study were as follows:

Young technology companies: Data General, National Semiconductor, Compugraphic, Digital Equipment, Marion Labs.

Innovative companies: Polaroid, 3M, IBM, Xerox, Texas Instruments.

Mature companies: Bethlehem Steel, du Pont, General Electric, General Foods, International Paper, Proctor & Gamble.

The study reflected the following salient facts:

[Dollar amounts in millions]

	Young technology companies	Innovative companies	Mature companies
1974 sales	$857.3	$21,517	$36,795
1969 sales	145.7	11,647	21,410
5-yr sales growth	711.6	9,870	15,385
Compound annual rate of increase (percent)	42.5	13.2	11.4
1974 employment	41,966	555,882	812,351
1969 employment	7,597	449,284	786,793
5-yr employment increase	34,369	106,598	25,558
Compound annual rate of increase (percent)	40.7	4.3	.6
1974 income tax provision	57.4	2,296	1,506
1969 income tax	13.2	1,528	1,034
5-yr increase	44.2	768	472
Compound annual rate of increase (percent)	34.1	8.5	7.8

The following conclusions can be drawn from this study:

The Young Technology companies, with ending sales only 2 percent as much as those of the mature companies, nevertheless hired 34,369 people or 34 percent more than the 25,558 hired by the mature companies over the 5-year period.

The Innovative companies, with ending sales only 58 percent as much as those of the mature companies, nevertheless hired 106,598 people, or over 4 times more than the number hired by the mature companies during the 5-year period.

While the mature companies increased sales and net income over the period at close to the same rate as the innovative companies, the mature companies accomplished this largely through utilizing available capital to automate production rather than through expanding their labor forces. Employment in the mature companies increased by only 3.2 percent over the five years compared with 27.7 percent for the innovative companies.

Finally, the innovative companies, with ending sales only 58 percent those of mature companies, and with ending employment only 68 percent of that of the mature companies over the 5 years studied but throughout the whole 5-year period provided substantially more revenue dollars to the federal government in income taxes. In the final year alone the innovative compannies provided nearly $2.3 billion or over 52 percent more in tax revenues than the $.5 billion provided by the mature companies.

Emerging innovative companies create products, services, jobs and revenue for the Federal Government faster than do our large mature companies. Such companies should and must be helped to flourish.

CAPITAL AVAILABILITY—AND THE LACK THEREOF

Mature large companies are the most capable of providing for their capital requirements out of internally generated funds. In addition, because of their size and maturity they have the easiest access to external capital. Investors preceive investment in such companies to be low risk. In addition, the new Pension Reform Act, ERISA, has tended to make pension fund managers more cautious in their interpretation of the Prudent Man Rule. This has resulted in making the resources of pension funds, the largest available source of capital in the country, largely available only to the mature companies, thereby severely reducing the growth capabilities of most small companies.

Unfortunately, innovative companies, which have a far greater need for external financing, are perceived to have a higher risk, and large segments of capital sources are not willing to fund these companies. The highest risk segment, the younger emerging companies, are having the greatest difficulty of all in raising capital. Without such companies there will not be any innovative companies in the future.

For the most part, innovative companies do not arise from rejuvenated mature firms. Once a company reaches a certain size, it often approaches its future with caution and reduced risk taking. While the policy is designed to protect the stability of the business, the result is a decrease in its ability to grow. There is a direct relationship between risk taking and growth in our economy.

The smaller, higher risk companies provide a good measure of the corporate growth in the country. Yet it is these companies that have the greatest difficulty in raising capital and in their early stage, attracting good management.

The following data on the venture capital industry show how little venture capital is presently being invested.

The National Venture Capital Association, which includes the major venture capital groups in the country, has commissioned a two-year study by Professor A. Ofer, Northwestern University, on the flow of venture capital. The most recent study showed the following for the Venture Capital industry (143 Venture Capital Firms):

[In millions of dollars]

	1975	1974
Investments in new projects not previously in the portfolio	52.4	80.6
Investments in companies already in the protfolio	58.9	101.3
Total	111.3	181.9

Professor Ofer's studies indicate that the flow of venture capital investment is slowing materially. His data also show how little money is now being directed by the venture industry into start-up or barely emerging companies:

[In millions of dollars]

	1975	1974
Amount invested in startups	15.6	12.9
Amount invested in 1st-round financings	8.1	37.5
Amount invested in somewhat more seasoned 2d-round financings	17.7	23.6
Total	41.4	74.0

Prior to 1973, the public markets were a significant source of financing for the successful emerging innovative companies. Firm public underwritings for companies with a net worth (prior to the public offering) of less than $5 million reflect the following pattern:

	Number of offerings [1]	Total dollar amount (millions)[1]
Year:		
1969	548	$1,457.7
1970	209	383.7
1971	224	551.5
1972	418	918.2
1973	69	137.5
1974	8	13.1
1975	4	16.2

[1] Excludes regulation A, best efforts, Government securities and foreign issues.
Source: Venture Capital Magazine.

As shown above, public offering declined from 548 companies (and $1.5 billion) in 1969 to 418 companies (and $918 million) in 1972 to an abysmal average of 6 companies (and $15 million) in each of 1974 and 1975.

Effective public markets for the successful emerging innovative companies serve a twofold purpose. First, they provide desperately needed external capital to companies at a time of significant growth in sales and employment. This follows their successful emergence from the very high risk start-up and early development stages funded privately by founders, friends of founders and, in many cases, venture capitalists. Second, they permit the early investors and venture capitalists, with locked-in private investments, to sell a portion of their holdings and thereby "recycle" some funds from their more successful early stage investments into new private emerging companies requiring venture capital.

Certainly there is no way to develop emerging innovative companies unless capital is willing to be risked to get them started and growing. Studies by Professor Ofer indicate that the amount required to start a company has been increasing each year since 1970. It now takes at least $2 to $3 million to launch an emerging innovative type company and many times this amount in equity capital to finance its growth.

This is a wealthy country and there is no shortage of capital that could be invested in emerging innovative companies. However, there is a distinct shortage of capital that is willing to be invested in such companies.

There are a number of reasons for this great change from the environment in which this country has grown and flourished:

Capital gains rates have continuously been increased over the years and the new tax law has increased the tax on significant capital gains to levels that are commensurate with taxes on ordinary earned income. In addition, many states also tax capital gains.

As a result the investor is receiving back less and less after taxes in return for taking the high risk of starting and backing new and growing enterprises. Nothing has been done to mitigate the high risk of such investing.

It has become more difficult to sell successful venture capital investments. New SEC rules inhibit the sale of such investments, and side effects of these rules have generally reduced the price at which such investments can be sold.

The stock market itself has reflected these changes. Stock prices of emerging growth companies are low . . . so low that venture capitalists cannot make sufficient profits on their winners to justify the high risks they must take or even to offset the losses on their losers.

About the only way a venture capitalist can make a reasonable profit is through the merger of the emerging companies with a large corporation . . . which only goes to consolidate the power of the larger corporations in the country.

Basically, the question regarding capital formation is—will the system self-correct to encourage once again the creation of new companies and the flow of more capital into developing companies, or have basic changes occurred in the system to prevent this from occurring?

While the answer is unclear, fortunately an increasing number of responsible people give evidence of being vitally concerned.

A survey by the highly regarded "Cambridge Report" (1st Quarter 1976) reflected a substantial 64 percent majority who thought that a "very serious" (25 percent) or "somewhat serious" (39 percent) problem existed with respect to "raising the dollars needed for business investment" in the years ahead. Even more encouraging, 72 percent favor private investment over government investment.

In another 1976 survey by the polling firm of Opinion Research Corporation of "thought leaders in Washington" the results are encouraging. "Thought leaders" were divided into three groupings: Legislators; Executive Branch and Regulatory Agency leaders; and leaders of unions, public interest organizations and the media. The question asked was, "How serious do you think the shortage of investment capital facing U.S. industry will be over the next 10 years?" The answers follow:

	Legislators	Executive branch and regulatory agencies	Unions, etc.
Very serious	57	57	20
Somewhat serious	21	33	45
Subtotal	78	90	65
Slightly serious	17	5	10
No shortage/or no answer	5	5	25
Total	100	100	100

Again, it is encouraging that 78 percent of the Legislators surveyed and 90 percent of the Executive Branch and Regulatory Agency personnel surveyed see "very serious" or "somewhat serious" problems in the area of capital formation.

Our new President is, himself, a small businessman who has expressed an interest both in expanding business and in expanding job opportunities, particularly in those areas which require minimum federal spending. New approaches to these problems are being sought by the new administration.

Hopefully, this awareness by the new administration and Congress will encourage action to be taken to improve the flow of capital to smaller and innovative companies.

FEWER ENTREPRENEURS AND MANAGERS ARE INTERESTED IN NEW AND EMERGING COMPANIES

There seem to be fewer entrepreneurs in the country interested and willing to start their own companies. In addition, fewer people are willing to leave the large corporation to participate in the risks of an existing younger company. Once a company has been started, it can only continue to grow if it is able to attract additional, highly trained and dedicated executives in such areas as marketing production, finance and research. Since the best such men will be earning high salaries in large companies, the small firm must find someway to entice them to leave their high salaried, secure positions and risk their future with the emerging innovative company.

What can entice a man to make such a move? Surely the smaller company can't compete with high salaries. It simply doesn't have the capital or budget, and it can't offer job security either. But it can offer excitement, challenge and the possibility of making a lot more money (if he can keep enough of it after tax payments) if the venture proves to be successful.

Founder's stock rules have been made much more restrictive in recent years and qualified stock options were eliminated in the Tax Reform Act of 1976. Only the non-qualified stock option is available as an incentive to induce skilled managers to associate with growing companies. With such options the recipient must pay taxes in the year the option is exercised (when cash is not readily available) rather than in the year of sale (when cash is available). Since the receipient normally has few other liquid resources, he is usually forced to sell a substantial portion of his stock just as it is received in order to fund the taxes he must pay. Such essentially forced premature sales of stock in the very company in which the entrepreneur/manager is working to build a growing successful business severely erodes his ongoing stake and hence motivation to continue building the business.

The key building blocks for the emerging innovative company are capital and management. Without adequate incentives for both, the ongoing formation of these vitally important businesses will simply not happen.

SOLVING THE CAPITAL AND MANAGEMENT PROBLEMS

Broad initial recommendations

Given the evidence that, in comparison with large mature corporations, the emerging innovative companies each year employ disproportionately more people and provide disproportionately more revenues through federal income taxes (to say nothing of the increased payroll and ancillary taxes available from the increased employment base), we recommend the following:

The Carter Administration, in its plan for reorganizing the Government, should give adequate authority to some entity within the Executive Branch which would focus full time on the needs of smaller emerging and innovative companies. This entity should focus on necessary incentives to promote adequate capital formation and on necessary incentives to attract qualified management from the relative security of large corporations to the far higher risks of small growing businesses.

The new administration should work closely with the House Ways and Means Committee, the Senate Finance Committee, and any other committees dealing with the problems of capital and management incentives for emerging innovative companies. The objectives should be to develop legislative tax and regulatory changes designed to expand the formation of these businesses and to attract capital and qualified management to them.

Until recent years, the private sector was effective in supporting new and smaller businesses. The Federal Government need not invest or spend valuable public funds to develop these businesses. With proper incentives, the private sector will again fund such businesses; qualified management will be attracted, as in the past; and the Federal Government will become more than a 50-50 partner through income tax receipts and payroll deductions from the successful growth of such businesses.

Longer range specific recommendations

The National Venture Capital Association, on behalf of its members and the emerging innovative businesses in which its members have invested, has a continuing program of reviewing the impact, both beneficial and adverse, of legislative and regulatory changes.

The NVCA is in contact with the Treasury Department, the Securities and Exchange Commission, the various staff and members of the House Ways and Means Committee and Senate Finance Committee and others. The principal areas of concern to NVCA are:

Management incentives.—Specific proposals to retain certain key benefits of incentive qualified stock options for managements of small emerging innovative companies were unsuccessfully presented to the 94th Congress. Incentive programs for managements of these types of business must be reestablished following the adverse impact of the 1976 Tax Reform Act if qualified managements are to be successfully attracted in the future. We stand ready to introduce specific proposals to the proper authorities.

Incentives to assist smaller growing business.—Graduated income taxes have long been recognized as equitable in the taxation of individuals. The corporate tax structure has differentiated only between those businesses either earning less than $50,000 annually or more than $50,000. This penalizes the smaller growing company much as the same policy would unduly penalize individuals. We stand ready to espouse specific proposals in this area to the proper authorities. We also stand ready to discuss the concept of providing specific deductions to smaller growing operating companies arising from net increased employment they may provide each year. Other proposals for the assistance of smaller growing businesses are under study.

Incentives to investors.—The Tax Reform Act of 1976 has resulted in increasing the minimum tax on capital gains. It has also adversely impacted the maximum 50 percent tax rate on personal service income by offsetting personal service income eligible for the 50 percent rate with all tax preference income, including one-half of realized capital gains. The impact of these changes further reduces the amount of capital gains which effectively can be retained after federal taxes to as little as 47.5 percent of the gains in certain instances (less any further reductions from state taxes on capital gains) whereas the risks of capital investment continue unabated. Consideration should be given to establishing lower rates for capital gains taxes and, simultaneously, removing capital gains entirely from inclusion as a tax preference item. The effect of this proposal would be be to clarify and simplify capital gains tax calculations and to eliminate the double taxation effects of the present system.

Incentives to encourage investment in already publicly owned successful emerging innovative companies by pension funds and other institutions.—The great institutionalization of the stock market and the increasing percentage of the nation's capital in the hands of pension funds is creating a shortage of investment interest in smaller sound growing publicly held companies with annual sales of less than $100 millior or so.

In Peter Drucker's new book, "The Unseen Revolution," he estimates that 50 percent of the equity capital in the country will be under control of the corporate pension fund managers by 1985. These men, in his opinion, are temperamentally unsuited and unqualified professionally to invest in the smaller type of publicly owned company. Yet, unless a way is found to tap some of this capital for emerging growth companies who deserve and need capital in order to keep growing, they will continue, as now, to be choked.

Some means must be found to strongly encourage penson funds and perhaps insurance companies and banks to invest in the smaller publicly owned companies. Perhaps this might entail the creation of special funds with capable professional management to make such investments. The pension funds, banks and insurance companies should be encouraged to invest a small percentage of their capital in such special funds and pay the somewhat higher management fees required to support such endeavors.

Clarification of the Prudent Man Rule under the new pension fund law, ERISA, must be issued by the Department of Labor in order to accomplish this.

Pension fund managers must also receive clearance to invest in another fund for the purposes indicated above. The present rules on fiduciary responsibilities often create problems and should be altered appropriately.

Increased liquidity and marketability for securities to enable investors to turn over and recycle investments in maturing business.—NVCA is having ongoing discussions with the Securities and Exchange Commission and has proposals currently before it to accomplish these objectives in limited fashion. We stand ready to discuss these and other proposals with the proper authorities.

In a related area, funds devoted to investment should be given higher priority for the benefit of the country, its economic growth and fuller employment than funds devoted to consumption. We recommend consideration of a program similar to that available to homeowners, for the deferral to capital gains taxes from profitable investments in smaller emerging growth companies, as appropriately defined, so long as proceeds from the sales of any such investments are "recycled" into similarly defined companies within an appropriate period of time.

Finally, we would urge a study of public trading in options of the larger corporations. Such a study may well demonstrate that capital utilized for these purposes is unproductive for the economy and is, in fact, draining away capital from other more productive although equally high risk uses, such as investment in the smaller emerging innovative companies. In this connection we would urge a study of the feasibility of a lower capital gains tax rate for any profits arising from funds invested directly into a company who qualified, by appropriate definition, as a smaller emerging innovative company. Funds so invested help to build businesses and increase employment. This type of tax incentive might assist in luring funds away from alternative, less productive, investments, such as publicly traded options.

Above all, whatever specific remedies are employed, we repeat that emerging innovative companies create products, services, jobs and substantial revenues for the Federal Government faster than do our large mature companies. Such companies are presently "an endangered species." They must be helped to flourish.

A Program of Tax Revision Proposals To Enhance Capital Formation for Growth Businesses

The broad objective of the following program of Federal income tax revision proposals is to encourage the formation and growth of new small businesses in order to encourage innovation, to develop technology and to stimulate employment.

This program is presented by the National Venture Capital Association as an addendum to its position paper "Emerging Innovative Companies—An Endangered Species." As discussed in the position paper, these small to medium-sized companies, which make a disproportionately large contribution to job creation and production of federal tax revenues, are denied access to traditional sources of capital at reasonable cost and are either constrained in their growth or penalized for it. The proposals set forth below would increase the availability of external investment capital for such companies, allow additional internal financing of growth through increased cash flow and allow these companies to attract and motivate key personnel. The impact of this program on Federal tax revenues would be more than offset by the benefits of an increase in private sector employment and the future tax revenues generated by increased economic growth.

Capital investment is the most powerful job creator in a free enterprise system, with each dollar of investment contributing several times its value to econimic activity and employment. The most meaningful incentive to capital investment is a substantial differential between the rate of tax paid on realized capital gains and that paid on ordinary income. With a sizeable differential, corporations are encouraged to retain and reinvest their earnings in new plant and equipment rather than paying earnings out in the form of dividends because shareholders then prefer such reinvestment and the resulting increased value of their stock as opposed to dividend income. During the 1950's and 1960.s when capital gains were taxed at 25 percent and dividends and interest were taxed at rates as high as 91 percent the United States became the most powerful industrialized country in the world. In recent years the differential between capital gains and ordinary tax rates has been decreasing (capital gains rates are now as high as 50 percent for individuals and ordinary income rates are up to a maximum of 70 percent and, logically, we have seen an erosion of capital investment.

Certain of the proposals in the program set forth in this paper seek to restore a substantial differential between capital gains and ordinary tax rates with the objective of stimulating investment by shareholders in smaller, growing companies and, in turn, stimulating these companies to expand rapidly and create new employment opportunities. It is only through such a constructive program of tax incentives that the future of our free enterprise economy, and the place of smaller more aggressive companies in it, can be assured.

I. QUALIFIED SMALL BUSINESS INVESTMENT CAPITAL GAINS TAX DEFERRAL

Proposed legislation.—Amend the tax code to provide for a deferral of capital gains tax liability arising from the sale of a Qualified Small Business Investment to the extent that the proceeds of the sale are reinvested in one or more other Qualified Small Business Investments within the twenty-four months after the sale. A Qualified Small Business Investment is defined as a security or securities purchased directly from a Small Business. A Small Business is defined as any corporation, partnership or proprietorship having less than 1,500 employees.

Existing legislation.—Capital gains arising from the sale of securities are taxed in the fiscal year of sale.

Commentary.—There is presently a shortage of capital for Small Businesses which is heightened by the current tax law that provides a disincentive to investors to roll over their portfolios by taking away a portion of the proceeds when a sale is made. A Qualified Small Business Investment capital gains tax deferral would provide proper incentives to investors in Small Businesses to roll over their portfolios more often and to reinvest the proceeds of a sale in other Small Businesses. The federal government would not lose tax revenue under this proposal; it would merely defer receipt of the revenue as long as the funds were being put to a productive and socially desirable purpose.

The enactment of this proposal would also reduce the Internal Revenue Code's inducement to owners of independent businesses to sell out (when they wish to sell out) to large corporations, whose shares are activity traded, in tax-free reorganizations so that they can postpone the capital gains tax on the sale. Under the proposal urged here owners of independent businesses whose investment was made while the business had less than 1,500 employees could sell the business to any buyer or group of buyers for cash and postpone the capital gains tax by reinvesting the cash in a Small Business of Businesses within the two years following the sale.

II. SLIDING SCALE FOR CAPITAL GAINS TAX RATE FOR LONGER TERM QUALIFIED SMALL BUSINESS INVESTMENTS

Proposed legislation.—Tax capital gains on sales of Qualified Small Business Investments (as defined in Proposal I. above) at rates of 30 percent if the investment is held for less than five years, 25 percent if it is held for more than five years but less than ten years and 12½ percent if it is held for ten years or longer.

Existing legislation.—Currently capital gains are taxed at 30 percent for corporations and at rates up to 50 percent for individuals with no differentiaion in holding period other than that required to qualify as a capital asset.

Commentary.—The present method of taxing capital gains discourages long term investment in favor of relatively short term speculation. It requires a considerable number of years and substantial risk to start a business and bring it to a level of sustained financial independence. Adjusting holding periods and capital gains rates with respect to Qualified Small Business Investments would encourage investors to invest in Small Businesses and to retain their investments in Small Businesses for longer periods and thus reward the financing and continued support of new businesses. Furthermore, the disincentive to sell a Qualified Small Business Investment after the investment had been held for a lengthy period of time would be substantially reduced.

III. REMOVAL OF CAPITAL GAINS FROM THE LIST OF TAX PREFERENCE ITEMS

Proposed legislation.—Amend the Tax Code to eliminate capital gains from the list of tax preference items which are subject to additional tax.

Existing legislation.—The Tax Reform Act of 1976 drastically increased the taxation imposed on tax preference items. A tax of 15 percent is now imposed on individuals' tax preference items (including one-half of capital gains) in excess of the greater of $10,000 or one-half of federal income taxes paid (with no carryover of unused exemptions from year to year). Prior to 1976 the tax was 10 percent and the exemption was $30,000 plus all federal income taxes paid (with a carryover from year to year of taxes not used to offset preference income). In addition, any taxpayer otherwise benefitting by the maximum 50-percent tax on personal service income is required to reduce his or her personal service income available for this 50-percent maximum tax rate by the amount of all of his or her preference income (including one-half of capital gains), which amount then becomes subject to ordinary income tax rates of as high as 70 percent. Prior to 1976 there was a $30,000 exemption for this purpose.

Commentary.—The effect of the current tax law is to reduce the attraction to investors of capital gains income as opposed to current income. This has the double negative effects on Small Businesses of discouraging persons from investment in Small Business securities, which are riskier and pay less current dividends, and of making it more difficult for Small Businesses to compete for key employees given the need to use stock incentives rather than current income as their primary compensation tool. It further reduces capital available for investment by increasing stockholders' desire for dividends.

IV. SMALL BUSINESS JOB CREATION TAX CREDIT

Proposed legislation.—Provide a standing tax credit of $2,000 per employee for each net new employee hired by a Small Business (as defined in Proposal I. above) with no limitation on the amount of the credit and with a carryover from year to year for amounts of the credit earned but not yet used to offset tax liability. Net new employment would be defined as the increase in the average number of full-time employees from one fiscal year to the next. Average employees would be computed by averaging the number of full-time employees at each payroll period during the fiscal year.

Existing legislation.—None. In 1977 Congress voted to grant a temporary employment tax credit to all companies but with an upper limit on the amount of the credit.

Commentary.—An increase in private sector employment is the only permanent, productive way to solve our country's unemployment problem. A stronger job creation tax credit for Small Businesses would both provide an incentive to young companies to hire additional workers and increase their cash flow (through reduction of tax) to fund business growth. Loss of federal tax revenue should be more than offset by the increased transformation of unemployed workers supported by public assistance into productive, tax-paying private sector employees.

V. SMALL BUSINESS INCENTIVE STOCK OPTIONS

Proposed legislation.—Amend the tax code to allow a key employee of a Small Business (as defined in Proposal I. above) who is the recipient of an Incentive Stock Option, and who does not elect to be taxed in the year of grant on the then value of the option, to defer payment of tax from the exercise date of the option to the earlier of the year of sale of the underlying stock or ten years after the grant of the option. Only key employees of Small Businesses would be eligible to receive Incentive Stock Options. The taxation of ordinary stock options would not be affected.

Existing legislation.—The Tax Reform Act of 1976 eliminated the Qualified Stock Option. Under current law an employee who elects not to be taxed in the year of grant at ordinary income rates on the then value of a stock option and who subsequently exercises the stock option is taxed in the year of exercise at ordinary tax rates on the difference between the exercise price and the market value at the date of exercise.

Commentary.—Smaller companies depend upon stock incentives to attract and retain key employees as they cannot afford the high salaries paid by larger companies. The current law unduly penalizes key employees of smaller companies who often must sell optioned stock at the time of option exercise in order to pay the required tax, yet are unable to sell the stock obtained from exercising the option due to the limited or illiquid market for the stock. NVCA's proposal does not suggest a reduction in tax but merely a deferral of the tax until the employee is able to sell his stock to generate cash to pay the tax.

Mr. MORGENTHALER. We have assembled today a panel of venture capitalists, one from California, one from Texas, one from Connecticut and one from Ohio to describe to you some of the problems that the industry is encountering. We believe there are serious losses to our country in terms of adverse effects on small business and the lack of formation and new technology enterprises, partly as a result of unintended harm of the ERISA legislation.

In summarizing, may I lay a brief groundwork about the entrepreneurial process with which the country is having some difficulty today? Basically, of course, to found a business there must be an entrepreneur, or a group of entrepreneurs, with an idea for a new product or a service. Such a group rarely will have enough capital, therefore, they will have to find venture capital, either from one of the professional groups such as we have here, or from individual sources.

If the business is successful in the beginning stages, it is later possible—usually—to attract institutional capital, later bank loans, and ultimately, then, some or all of the company can be sold to public investors who can undertake the more moderate risk level of a successful company and provide some of the additional capital that these companies need.

Basically, of course, the sources of such capital cannot normally provide the early startup money and it is necessary to have venture capital in this process.

Fundamentally, the cycle today is not working very well in our economy, not working nearly as well as a few years ago. Yet, these are the companies that go on to be the innovative growth companies our society so badly needs today to give us new technology—the technology that not only advances our standard of living but also enables us to sell to foreign countries the products that will pay for our oil imports and mineral imports and the other things that we need.

Finally, some of these will go on to be the blue chip companies of future years. If the cycle is not working properly, the question is, who is not doing his share in the cycle, and why?

Clearly the process has become clogged up, at least to some degree. Different people give different reasons why the entrepreneurial cycle is not working well today. One of the problems is that everyone blames it on some one factor in the investment process.

If you talk to entrepreneurs, many will say there are very few venture capitalists left. Those left are completely invested in companies that they cannot take public, and thereby, free up some of their funds for recycling.

Some venture capitalists will say, on the other hand, that there is plenty of venture capital available but good entrepreneurs refuse to leave the sheltered refuge of good jobs and the fringe benefits of the larger established businesses.

Clearly I do not think we can blame the banks. Their record of losses in recent years indicates they are taking all the risks that anybody should reasonably expect them to take.

All agree, however, that the public market for smaller companies is certainly not doing its share today, and we believe pertinent to this testimony that institutions, especially pension funds, are not able to do their share in the entrepreneurial process.

Much of the reason for this is the prudent man interpretation of ERISA. My colleagues will go on to explain how and why this bill Senator Bentsen is sponsoring will, in our opinion, improve this situation.

The entrepreneurial process that we depend upon so heavily in this country is little understood, but the enterprises that it produces are job intensive rather than capital intensive as the larger organizations are so wont to be. A recent study indicated that six of the largest corporations in the United States—household names—in the course of a 5-year period produced only 25,000 net new jobs while they increased their sales by something like 50 percent. We will enter the statistics in the record.*

Our smaller organizations, at a tiny fraction of those sales, increased jobs by 50 percent more than these six larger organizations did. It is probably not an exaggeration to say that the companies financed by the four men sitting at this table over the period of time produced almost as many additional net new jobs in the economy as did these six large organizations.

I would like to pass you on to my colleagues at this time, and first I would like to present Dick Hanschen from Texas.

STATEMENT OF RICHARD J. HANSCHEN, DALLAS, TEX.

Mr. HANSCHEN. My name is Dick Hanschen. I am the founder of the New Business Resources of Dallas, Tex. I normally introduce myself as a venture industrialist rather than a venture capitalist, because my activities are directed solely at starting new companies, not just in investing.

I draw on 20 years' experience I had in industry at Texas Instruments and Honeywell, and with this I explore new technologies to see what products may be manufactured, estimate the total potential market and lay out a business strategy for a new company. This all makes sense.

I invest my own and other people's money, select a management team and then, when necessary, I tend the store to make certain things work out. In the last 8 years I have averaged starting one new company a year. A well publicized company, Mostek, was started in 1970 and will do $85 million this year. They employ 2,050 people in the United

* See p. 95.

States, have a payroll tax of $6.8 million. To date, they have paid $13.2 million in corporate taxes. They are currently putting up a new facility in Dallas of 200,000 square feet that should employ another 1,000 people there.

Today, Mostek stockholders that have invested in common stock have not received one dividend, and probably will not receive any dividends in the foreseeable future. The sole incentive motivation to be a stockholder is stock value appreciation. That appreciation is dependent on Mostek's ability to continue to grow at a rate of 30 percent per year.

Since a company like Mostek can only grow at a 15-percent rate from internally generated profits, Mostek will need to raise long-term capital as well as attract long-term, competent personnel. Long-term capital sources will require more than a banker's return and exceptional personnel will demand more than a competitive salary. They both look to significant stock appreciation, again, to achieve these additional returns.

Going back to my opening points on my activities, I think the thought process necessary to form a new business must have much in common with the thought processes of all persons managing man, money, and machines, whether they be industrial pension fund managers or government leaders.

The first criteria that I try to establish is the new technology will have a cost-effective impact that should result in a 5 to 10 times improvement over what exists. If not, I just label it as product extension where it is probably going to be done by existing companies.

Senator BENTSEN. Say that again.

Mr. HANSCHEN. I take a new technology and try to see if it will have a cost-effective impact that will result in a 5 to 10 times improvement. A specific example is a company medicus which provides an electronic system in hospitals that will allow the medical hospital to operate more efficiently, to reduce their cost-per-patient stay 30 percent by efficient processing of people through, like running products through a factory.

The reason I am in that business is because the cost of that system to the hospital is one-fifth of an IBM system. The four electronic equipments that make up that system come from four different companies and all four of those companies were financed as venture capital companies. I did three.

This is the impact we are looking for. If it is a 20-percent improvement, I feel that IBM will eventually do it themselves. I am looking at an order of magnitude impact.

Senator BENTSEN. You are able to find an average of one a year that can do that?

Mr. HANSCHEN. Yes.

The next thing I do, I lay a business plan based on a very simple textbook fact, that every product has a life cycle. Each product will go through a cycle of development, growth, maturity, and decline. I would like to repeat that for emphasis, because it is a theme that I am here to expound.

All products go through life-cycle phases of development, growth, maturity, and decline. I stress that because I believe that is just as true of men, companies, industries, or companies. Unless one can establish in an organization a continuing creative element that will always be making something new to build upon, maturity will lead to decline.

This leads me to believe that anybody investing only in mature situations such as pension fund managers have interpreted the recent bill will be limited to investing in mature situations, may be taking unusual risks and passage of time will turn their mature investments into declining situations with rapidly eroding market values.

The erosion rate—I have seen some charts that show stock values tend to fall at five times the rate that they increase in value. This is related, really, to how quickly confidence is lost, as to how slowly confidence can be got.

It seems to me also that a pension fund manager, much like myself, must continuously sharpen his intelligence and inputs by intimate knowledge and participation in developing technologies, markets, industries, in order to invest later in growth companies and growth industries and in that way participate in future, mature investments.

The impact of much of what fellows like us do has resulted in new industries. The main frame computer industry did not start the computer industry. Digital Equipment was done by venture capitalists. The minicomputer industries are not starting this new field of microcomputers. It is all done initially by venture capitalists.

You can go on through that. The impact of our efforts is new industries. I make that point because it would seem to me that some of the problems our Government is trying to solve, such as more employment, more tax revenue, would lead to a strategy, in the national interest now, for putting special importance on the development and growth of new industries, in addition, to extending the life of mature and declining industries.

I say this because recently I did engage in assisting another country in laying their strategic, 10-year industrial growth plans. Their prime effort was aimed at developing new industries for goals of exportation, particularly to the United States. I declined to participate as a venture industrialist in these countries, although the risk-reward ratio is one of the best I have ever been offered.

In examining my motives for not acting in that situation, I would say the prime cause is that I am fully extended with the opportunities that I have close at hand. Also, with four sons, the oldest one who has joined me as my partner last year, I am still not yet inclined to sell the farm, which has been a pretty good producer.

I personally feel that the loss of confidence that growth capital will flow into developing companies, those below $100 million revenue, has been the prime reason for the decrease of startup capital and development capital in new businesses in the United States.

Senator Bentsen. Say that again?

Mr. Hanschen. I personally have a conviction that the loss of confidence that growth capital would follow in sequence into developing companies, those below $100 million, this has been the prime reason for the decrease in flow of money into startup companies and into developing companies.

This is the chain of financing that I talked about that we really did not want to go out and commit yourself to the first phase of this, if you do not see sources of capital later on. I can talk from personal experience of what I have done, I really have done within the financial capabilities of my own family and my sons, without ever looking at the outside world for other capital until this atmosphere clears up somewhat.

I am really looking forward to a renewed program that will allow responsible participation. Not being a financial man, I really do not know the word "prudent" from a legal sense of the meaning. I really think it is possible that responsible participation by pension fund managers and companies in their judgment are doing good the things that will lead to significant growth, with the resulting stock value appreciation that will feed back and give these stockholders, these employees, these long-term capital suppliers, the same thing that the pension fund managers are looking for.

Thank you.

Senator BENTSEN. That is very interesting.

Mr. Dennis?

STATEMENT OF REID DENNIS, SAN FRANCISCO, CALIF.

Mr. DENNIS. Senator Bentsen, I am Reid Dennis from California, and I come to this hearing today trying to bring my points of view from several different vantage points.

For 21 years I was investment officer at a major financial institution, American Express Co. and various predecessor companies that I will not go through, with the most recent position there being as president of the American Express Investment Management Co. and later its chairman.

I also have been an active director and officer of numerous small companies and have been active in the venture capital business, primarily on the west coast, for nearly 25 years.

I was successful in getting both American Express and one of its predecessor companies into the venture capital business and directed those particular programs for my employers, and they were both very successful programs.

I have a couple of technical comments on S. 285 that I would like to make, sir, from my point of view as a professional investment manager. The first one relates to your section 4976 on the top of page 3, the limitation related to more than 5 percent of any class of security.

I think the words that bother me are "any class of security" and would think the language would make more sense to investors and would actually be beneficial to pension plan beneficiaries if the staff would consider changing that language to read "5 percent of the voting securities" or "5 percent of the equity securities" including, for the purpose of the calculation, any securities that were convertible, as though they had indeed been converted.

There are many times when a pension plan can get a benefit by having a senior position. I do not think they should be limited to 5 percent of that particular class of securities. I think what you are concerned about here is concentration, and I would suggest that that be considered.

Senator BENTSEN. I think that suggestion has some merit. We will give it some study.

Mr. DENNIS. Thank you, sir.

The second technical question I have does revolve around section 3, modification of the prudent man rule which we are talking about today and which we are very much in support of.

That is the limitation again, although it has some modifying language, essentially is controlled by the 2-percent limitation, controlled by market value of securities, and I question why it should not be controlled by cost. It seems to me that my experience would indicate that any limit—most institutions will not go close to the limit because they do not want to exceed it, that if you do relate it to market value, then those that are successful in this field might exceed the limit and therefore be prevented from doing more in the field. Those that are unsuccessful and whose market value of unsuccessful investments may go to 0, then they would be free to invest another 2 percent of their assets in such things, so that I think——

Senator BENTSEN. It might run into a Mosstech.

Mr. DENNIS. Yes, at least, that is the hope. That should be the objective of this kind of money, if we are looking for small and emerging growth companies.

I frankly feel the cost is not only workable, it is more rational. In many of these small companies it is really very hard to determine what true market value really is.

Senator BENTSEN. That is an interesting suggestion. The 2-percent maximum is put on there really to protect the pension beneficiary, to be sure that someone does not go too far in going into situations, and obviously that problem does not exist if they had been very successful.

Mr. DENNIS. That is correct.

Senator BENTSEN. I think it would be a good approach.

Mr. DENNIS. It would simplify the language of that particular section. There is some modifying language that gives you exceptions to market value. I think all of that could be done away with, frankly, by relating it to cost.

Senator BENTSEN. Let's take the other approach. Suppose they have really picked themselves some winners and the market value has gone to 0 and they still show themselves with a cost basis——

Mr. DENNIS. There are some reliefs to that. They could, indeed, sell the security and get it off their books, and therefore have it disappear that way, but the main thing they would have to recognize the loss and take the loss and have a transaction, which I think is good discipline.

I do not see any disadvantage in using costs that would not also, in effect, be here if you were using market value.

Senator BENTSEN. Let me think that one through, because I think you make a good point.

Mr. DENNIS. Those are the only two technical questions that I have. I think that the other thing that I would like to mention briefly is the modification of the prudent man rule.

As you have proposed it in section 3, it is really a permissive piece of legislation. It is not a forcing piece of legislation at all. It is not a requirement, it is a permissive piece of legislation, and I think that it will increase the funds that are potentially available for investment in smaller businesses.

But, like the saying of leading a horse to water, you cannot make him drink, it is not going to force it to happen. I think that this legislation, this language, will encourage the formation of other investment firms, such as the one that I currently represent, Institutional Venture Associates, which represents seven major financial institutions and acts as their agent in investing money and so on in emerging companies.

One of the things that is unusual about many of us who are in this business is we frankly look at this kind of legislation as increasing the competition of business, and I think it is unusual to find a group of businessmen who would come before you and say, we would welcome that increased competition.

There are more opportunities around than we frankly have the time or the personnel to handle. The nature of the business of investing in small companies is not one that I believe you can institutionalize. I do not believe that it is one that you can write a rule book or and say to a staff, here are the set of rules that have worked for me for the last 20 years; go out and apply them.

It is very much an individual business and it is an extremely time-consuming business, as Mr. Hanschen has already pointed out. We frankly recognize it will bring us increased competition; we welcome that.

Since the formation of Institutional Venture Associates in April 1974, my partners and I—and there originally were four of us, now three of us—have reviewed some 800 different proposals. That is at the rate of one every business day, and we do not count, or log, in the total those we can turn off over the telephone, those that are inappropriate. We try to keep our bookkeeping in keeping track of these things to a minimum. There are still 800 of them in the 3 years we have been in the business. Out of that 800 we have made between 7 and 8 investments. It is about a 1-percent selection process.

That number, frankly, is too low. I am convinced there are more than 1 percent of those proposals that deserve being financed by somebody. They did not happen to fit our particular fields of interest. They did not happen to fit our time allotments.

Frankly in this business we run out of time before we run out of money. What I am encouraged about in terms of your bill is the fact that it will encourage more people to put more people to work, more funds will put more people to work.

That is something that the next witness will also talk about. But at the present time, this business is too selective. Those of us who have our funds together would frankly be more selective than I think is good for the health of the economy and the Nation.

I would say one other thing from the point of view of an institutional investment manager. Institutions have had a widely varying experience in the venture capital business. It has depended largely in its timing, and those who entered this business in 1968 and 1969 when it became very popular to do so largely have had disasters only since. There have been many disasters.

It depends, No. 1, on timing. It is dependent upon the abilities and the experience of their personnel and staffs, whether they want to devote that kind of personal resource to managing a very small percentage of their assets.

Surely one of the reasons why I left a major institutional position is the fact because a big, financial institution cannot afford to have its senior officer go out and work with such a small percentage of their assets.

Senator BENTSEN. That is why I do not think you will get a lot more competition, for that very reason. You can have larger sources of capital available to those people who can devote the time and have unique capabilities of searching out and following through on those types of ventures.

Mr. DENNIS. I think you are right, sir.

The other thing I think is important in this whole institutional process is that you have to have a friend in court, if you are on one of these institutional investment staffs. You have to have the interest and support of the top management of your firms.

You have to have the interest and support of either the directors of the firm or the trustees of the firm, whatever the setup may be. If you do not have somebody who believes in this process at the top, it just is plain not going to be done at the staff level. No question about it.

I think that we are fortunate in our own firm in representing institutions who believe there is a responsibility to the system to recycle at least some small percentage of the dollars back into trying to start these companies that are going to be the leaders of tomorrow.

Thank you very much.

Mr. MORGENTHALER. Mr. Chairman, our fourth participant is Stewart Greenfield. I think this is a particularly interesting example of a very successful venture capitalist who, because he started to put a fund together after ERISA legislation got in, has, in effect, had great difficulty doing so.

STATEMENT OF STEWART GREENFIELD, DARIEN, CONN.

Mr. GREENFIELD. My name is Stewart Greenfield. I am chairman of Charter Oak Enterprises, a venture capital services company located in Darien, Conn. My colleagues and I comanaged a venture capital fund from 1970 and 1974 as officers of an investment banking firm. A substantial portion of our capital was contributed by 10 pension trusts, one of which was the Wachavia Bank which Senator Bentson quoted earlier.

We made investments in 36 companies and 34 of those companies are still in operation. These companies have grown to employ an estimated 17,000 people. The total revenues of these companies is over $1 billion.

The return on the funds invested, even in these difficult times, have ranged from 11 to 25 percent, compounded annually and will yield an estimated total of $34 million in profits, most of which goes to these pension funds. This is on an average capital employed of $13 or $14 million.

A number of the companies that were generated are highly innovative. We feel that they have made important contributions to the American economy.

After our stint in managing those funds, for a number of reasons my associates and I thought we could even be more effective as an independent organization. On the basis of our performance record, we left our old firm to start a new venture fund. Our timing turned out to be very unfortunate, because we left in mid-1974, several months prior to the passage of ERISA. We were making substantial progress toward raising our fund when the implications of ERISA became recognized and we lost our principal potential investors.

One of those, by the way, was the Chemical Bank which Senator Bentsen also quoted. We had talked with them. They had expressed not only great interest, but concern that a greater flow of venture capital was necessary to stimulate the economy. They thought it was their duty to do this, but then found themselves frustrated by provisions in ERISA.

For the last 3 years instead of managing funds, we have worked as advisors to a number of formative companies. We have assisted them in solving financial problems.

It is still our intent to start a new fund and the passage of remedial legislation is something that we see as a key in our ability to do this.

Looking at the history of the problem, in the 1950's and 1960's, a number of pension fund managers experimented in investing in small private venture companies. They soon learned that investing in ventures requires a different focus and talent than investing in large companies. What they came to do was invest through professionally managed venture capital funds rather than using their own staffs to do this kind of thing.

In most cases, in doing this they felt comfortable operating under State prudent man statutes. In the period of 1968 to 1974, an estimated 50 venture capital funds were established with substantial capital contributed by pension funds.

—Since the passage of ERISA pension funds have made virtually no investment in venture capital. To our knowledge, the level was 0 in 1974 and 1975 and there was a matter of somewhere between $5 and $6 million believed to have been invested in 1976.

Certainly from all that we have gathered in discussion with members of the committee, it appears that the intent of Congress in drafting the reform act was to increase the rate of investment in smaller companies through an emphasis on the diversification of portfolios.

There are two aspects of the ERISA legislation that brought about these unanticipated effects. The simpler of the two has to do with a technicality in the act. The act charges the trustee of a pension fund with responsibility for the acts of those to whom he delegates investment authority, if those parties are not registered under the Investment Advisors Act of 1940 and are not banks and insurance companies.

The act can be interpreted as reading that trustees investing as limited partners or minority shareholders in a venture capital fund, and having no authority whatsoever over the action of such entities, are personally responsible for improper acts of those venture funds.

Trustees, as a class, are not very bold individuals and few would be willing to expose themselves to such, albeit remote, liability.

The second major problem has to do with the question of prudence. The section of the act on the prudent man rule does not provide a very clear, certain standard of prudence against which venture capital funds can be measured. In view of the exposures under ERISA, counselors to investment managers advise that they are exposed to suit if the value of the venture investment declines.

Senator BENTSEN. I would say that I have to go for a few moments to handle an amendment in another committee and Senator McIntyre will chair this hearing. I am deeply interested in what you have testified to. That is quite a track record you have, and I will be examing your testimony, the part of it I missed, in the record. I hope I can get back.

Senator McINTYRE [presiding]. Please continue.

Mr. GREENFIELD. Part of the problem is a question of the risk to the pension fund manager as compared with his potential rewards. Typically, a large pension fund will pay a management fee to its managers of one-quarter of 1 percent of the assets under management.

On this basis, if we compare the situation of a $1 million investment that doubles in size and the same investment that declines 50 percent, the gain produces income to the management firm of about $2,500 whereas the decline might cost the firm $500,000, or 200 times the potential gain, and that is very, very distasteful, of course, as a potential risk to a pension fund manager.

A number of investment managers feel that the potential yields of investment are substantially higher than other kinds of investing, investing 1 to 5 percent of their portfolios in funds that can contribute greatly to their performance.

Others feel that it is a patriotic duty to support the formative industries that have helped preserve America's technological leadership and account for substantial employment growth. However, the risks imposed by ERISA are too great, and such investment managers have not been willing to make venture investments. The result is a much lower rate of venture investment and many fewer growth companies are being formed today.

We see the Bentsen bill, S. 285, as an antidote for the consequences of the vagueness of the prudent man rule as expressed in the current act. The provisions of the law against self-dealing are not affected by S. 285, and it is these rules that are most effective in curbing abuse of pension funds.

In the case of single employer defined benefit plans, which, incidentally, are the source of almost all venture investment by pension funds, the employer is required to make up for the experience losses in the funds investments.

For these plans, and for solvent employers, the principal effect of the prudent man rule, therefore, is not to protect the employee but the employer, who generally has other, quite adequate devices for protecting his interests. I therefore urge most strongly that section 3 of S. 285 to be enacted.

Thank you.

Senator McINTYRE. Thank you.

You are nongovernment, small business investment companies, are you not; similar to the SBIC's—Small Business Investment Corporations which are supervised by the SBA?

Mr. GREENFIELD. There are many members of the organization who are, but we are not SBIC's.

Senator McINTYRE. But, you are private, nongovernment companies who look solely to the private sector for investments?

Mr. MORGENTHALER. That is right, sir.

Mr. GREENFIELD. The reason we do not take advantage of the SBIC regulations, is that we have much greater flexibility in working in these companies as independent entities.

Senator McINTYRE. Many States, including New Hampshire, have a "prudent man rule," so we would like to know: What is the significance of ERISA's change from the applicable State prudent man rules to the new, Federal prudent man rule?

Mr. GREENFIELD. It is in the garnishing of the rule rather than the substance. Let me describe that.

Before ERISA, a fund manager investing in a venture was subject to exposure under the prudent man rules, chiefly to the trustee of the fund. He could achieve an agreement on policy with the trustee. Under ERISA, the A.T. & T. fund manager, for instance, is subject to suit from 500,000 people. He has no way of arriving at a reasonable understanding as to whether or not his act is going to be considered prudent by those 500,000 people, whereas under State law, working with a trustee, you can very readily determine that there was agreement on that subject.

Senator McINTYRE. You believe that was just a happenstance that occurred? Were the people who put ERISA together looking for a tougher, or more complex, prudent man rule than existed in the States?

Mr. GREENFIELD. I do not think so at all. I think there was an attempt by people who drafted the legislation to improve the prudent man rule and render it more flexible. It is the risks and exposures presented elsewhere in the act that causes the problem.

Senator McINTYRE. Apparently Mr. Chadwick testified that the "modern portfolio theory" would accommodate venture capital investment. Is there anything short of legislation that would allow agencies and courts to recognize this theory?

Mr. GREENFIELD. I would say "No." It is necessary to provide for legislative relief before the fund analyzers would feel sufficiently comfortable to invest in ventures.

Mr. DENNIS. My answer is also "No." I think there are very few people, modern portfolio theory is something that is subject to definition and changes as time changes. What is modern today is outmoded tomorrow, so that you would be shooting at a moving target.

I think the problem with ERISA, whoever wants to shoot at you there has all of the benefit of hindsight as to what was prudent based on today's facts and based on the results of the investment many, many years after it was made. Does it now look like, when you reconstruct, that it was a prudent thing to do? If you lost money, probably no, it was not, and the problems that you have—I can cite you one example through my own experience and I am sorry Senator Bentsen is not here, because it was a Texas company our company invested in.

We were an insurance company subject to all sorts of State regulation. We put $1 million in a Texas company that later had a market value of over $40 million and was the largest, single tangible asset that the company had. The attitude of our own directors, when they look back on it, if we were able to make that much money in that investment, it probably was risky at the time we made the investment and we never should have made it in the first place.

That is the kind of circuitous thinking you get into when you look at these things in retrospect, and I do think that you definitely need legislative relief to, in effect, give a leeway clause to the prudent man rule, whether it is 2 percent—the number 2 percent, I understand there is also some legislation on the Hill that has a 5-percent clause. The rate is really immaterial, as long as there is some relief.

Senator McINTYRE. I have an excerpt from the Kansas Federal Reserve Bank magazine that gives the asset size of financial institutions, and it says that pension funds would rate about second in holdings in total assets. The figures here are $445.4 billion held in pension funds. That is more than the saving and loan associations have, they are at $338.4 billion.

That is exceeded only by commercial banks with $958.4 billion.

What you think of Senator Bentsen's proposal, S. 285, with the 2-percent leeway; is that 2 percent too much, or do you think it is a good figure? That could release $8.8 billion.

Mr. DENNIS. This is permissive legislation, not forcing legislation and there are many, many organizations included in that total.

Senator McINTYRE. Two percent is a good figure?

Mr. DENNIS. It is a good minimum figure.

Mr. GREENFIELD. Before the restrictive legislation was passed, roughly 100 pension funds made such an investment.

Senator McINTYRE. Say that again?

Mr. GREENFIELD. Before the restrictive legislation was passed, roughly about 100 pension funds invested in venture capital funds. We think the same pattern would apply in the future if the 2 percent basket is enacted.

Mr. MORGENTHALER. We think strongly 2 percent is not too much. I believe Canada and certain life insurance companies in the past have used 5 percent. It is entirely optional. Many people will simply not participate, no matter what, unless they are being compelled. I really do not think that they should be compelled.

I think this will clarify the fact that these are not, by definition, imprudent investments. This is one of our concerns about the modern portfolio theory. I would hate terribly to have to defend my judgment in an investment being viewed on an after-the-fact basis with that kind of investment theory.

We totally agree with the belief of Mr. Chadwick in this. I would not want to use it for a legal defense.

Senator McINTYRE. Treasury testified yesterday that freeing up this 2 percent from the pension plan, bringing it up from the prudent man rule, that they would be opposed to this on the basis that it would "eliminate all protection against imprudent investment." I suppose that is testimony that we would have to expect from Treasury.

Mr. MORGENTHALER. I think we would say in the first place a great deal of it depends on how one defines prudence and I think we would all feel that a very diversified portfolio is perhaps the most prudent way of investing with due investment manager judgment on each of the investments being put in.

One simply can no longer believe that it is prudent to concentrate all of the $400 billion-plus assets that you mentioned into the stock of 200 or 300 large corporations and having the pension managers outguess each other, selling them back and forth to each other as fluctuations occur in the values of each corporation.

It is far better to diversify this over the whole assets of the country to provide capital to the smaller businesses which are going to have the growth. I think the record of most of us is far better in this last 6- or 7-year period than practically any pension fund that we are aware of, although we supposedly invest in risky enterprises.

In fact, our diversification accomplishes the prudence and participated on this basis, it is a more prudent thing for a pension manager to put a more limited portion of his assets in these new enterprises, some of which are going to grow far faster and provide far better yields than merely concentrating in the few large corporations.

I also think it is a very unfortunate use of the country's tax subsidized assets. Your writeup on the bill indicates there is something like a $4 billion tax subsidy given to the industry and to subsidize the concentrating of those assets into very few corporations which again hurts the small businesses that are helping to subsidize that tax program.

Senator MCINTYRE. You represent private venture capital organizations. How many such companies are there, to your knowledge, in the country? Do you have meetings? Do you ever get together and talk about your common problems?

Mr. MORGENTHALER. We are members of the National Venture Capital Association. I happen to be the current president. There are about 70 members of our association, of people who have capital who provide funds to new and merging businesses on a continuing basis and who work with these companies.

In addition, of course, there are several hundred of the small business investment companies, some of whom are also members of our association. The directory lists about 600 sources of venture capital in the United States, but most of these people are not providing it on a continuing basis. They are corporate finance people who are money finders or facilitators in the transaction, middlemen of some sort, rather than people who are providing the capital themselves.

Senator MCINTYRE. There is no uniformity to your table of organizations?

Mr. MORGENTHALER. No. We tend to work in a somewhat similar manner but are highly individual organizations.

Senator MCINTYRE. Would you have, as a part of your organization, people who work for you who may be expert in some field? Or, would you go out and hire that "out of the house," so to speak, and bring in somebody knowledgeable in a particular field and say: "here, look at this investment possibility, what do you think of it?

Mr. MORGENTHALER. More customarily the latter. Would you gentlemen agree?

Mr. DENNIS. My background has been in the field of finance, primarily. I was originally an electrical engineer, so long ago I do not even recognize the field anymore.

Of my partners, one has a Ph. D. in electrical engineering from Stanford and the other is a graduate of MIT in electrical engineering and an expert in the consumer products peripheral business. So among my own partnership staff, among the three of us, I have one with a Ph. D. and a good scientist in things like electro-optics and electronics and that sort of thing and one very good man in business equipment peripherals.

If we need something beyond that, we will go out and get expertise from the outside.

In most of the venture capital firms that we are familiar with, you will find the partnership staff itself usually has pretty good technical background.

Mr. HANSCHEN. I think that is true. Most of us tend to specialize in the area we are going to invest in. You will not find us in real estate and in electronics. You would find us in one or the other, and we do that for intelligence reasons.

We have a continuous flow of information regarding a very narrow segment. I have a little business model I follow and the companies have to fit together. They have to make sense. Even a good investment, if it does not fit my model, would be rejected. I think this is pretty common.

Mr. MORGENTHALER. I think it is fair to say, Senator, throughout the industry, people, while they make more investments perhaps in some segments than others, nevertheless basically are looking for attractive investments. My own firm has financed many computer companies. We are also involved in the largest pickle company in the United States.

Senator McINTYRE. What is the rate of mortality of these venture capital companies in your experience?

Mr. MORGENTHALER. In the companies we invest?

Senator McINTYRE. Your outfits. Do a lot of them fade away?

Mr. MORGENTHALER. In the late 1960's, there were a great many people who became wealthy by other means, through speculation in the stock market, that kind of thing, who entered the venture capital field. I would say yes, it is true, that most of those have passed away.

Today, of the professional capital, the professional group of approximately 70 or 80 people we mentioned, these are the professionals, the survivors of the 1970–75 depressed period. I would say the mortality now is very low in that group.

Most of our people today are survivors. They are good people who should be able to get funds and who are unable to do so, or who have been unable to do so. It is rare to hear of many of our members going out of the business today.

Mr. DENNIS. I think it is fair to say that there has been a hard core of people who have been in the venture capital business and have stuck with it in good times and bad.

Senator McINTYRE. How long have you been in it?

Mr. GREENFIELD. I have been actively involved in it, in this role for 7 years.

Senator McIntyre. You, sir?

Mr. Dennis. I have been in the business for nearly 25 years.

Mr. Hanschen. Eight years.

Mr. Morgenthaler. Thirty-two years in starting up and managing small companies, nine years continuously nothing but venture capital.

Senator McIntyre. I do not have the average size of the pension fund. Could any of you give me an idea when you are talking about assets?

Mr. Greenfield. The average size of the myriad of pension funds is pretty small. It was stated that there are 1.6 million plans in existence. The average thus is about $30,000.

Senator McIntyre. What investment methods are used by the pension fund? I have the impression that they just want blue chips and government bonds? Do they use a whole flock of advisers?

Mr. Hanschen. Many are managed by a bank. The pension funds that are managed by a bank, you have a bank trust officer who operates it. They put my money that I have in the pension fund in bonds. I got an 8 percent return.

Senator McIntyre. Looking at these private pension plans, I have a question here. I would like you all to comment on it briefly.

Private pension plans now provide the main source of support for millions of Americans and millions more who will retire in the years ahead. These retirees are not earning and must be supported out of the gross national product that active workers are producing.

What is the role of the venture capital industry in helping to improve the productive capacity that will support retirement security in the decades ahead? Do you think there is a strong place for this venture capital you are talking about?

Mr. Hanschen. I would like to speak to that.

I am absolutely convinced that our people across the Nation start new industries and we trigger off new industries. The semiconductor industry was very much done by venture capital. It triggered off a whole myriad of things. It resulted in the growth potentials of the calculator industry.

Up until that time the technology was vacuum tubes and calculators could not utilize vacuum tubes. We have seen the calculator industry move to the United States. We have seen the wristwatch industry because of the semiconductor industry, move back to the United States from overseas.

If it is necessary for a company to have new product lines it is necessary for a country to have new industries continuously.

I think it is one of the most important contributions that we do, generating these new industries. We do it with self-interest and good return on investment. We aim, with our money, to try to achieve a 30 percent ROI, return on investment, compounded annually.

Senator McIntyre. You mentioned small business investment companies, federally chartered companies. Do they represent a sizable portion of your industry, if you put yourself together, or just a small segment?

Mr. Morgenthaler. No, they represent a very large segment of the industry and probably the major difference is the various restrictions under which they operate. Many of them operate similar to our private investment capital companies.

The private venture capital companies are more apt to invest in new ventures at an early stage when the ventures are losing money, or at least are making so little that they are unable to pay interests on their investments. The SBIC's are normally substantial users of Government-sponsored bonds and must pay interest on it, therefore, they must have a source of income to pay that interest and the new ventures in very early stages are often unable to afford the interest.

Mr. HANSCHEN. There are two limitations on SBIC's. One is the amount of capital they can invest in any one situation. It is 20 percent of their equity that they have. This would mean that they have leverage 4 times and have to invest in 20 companies to be fully invested.

The other thing, because they have to pay interest, they cannot really make a common stock, long-term investment. They have to make it in a venture that pays them interest sooner. Often these developing companies are forced to pay out of capital interests if they are using an SBIC. What we really need is long-term capital. We want this thing to work. It depends on its return and stock value appreciation.

Senator McINTYRE. I notice here that two of your representatives are from Texas and California, one from Ohio and one from Connecticut. Is most of the activity of your membership in the Southwest and Far West?

Mr. MORGENTHALER. Not at all, Senator. We all invest nationally. Unfortunately, not all of the ventures occur in ony one location, although a few years ago Boston was a highly prolific source of investment. In more recent years, California; increasingly, the Southwest has been an increasing source of opportunities.

I think perhaps we all live where we like to live or where we happen to start in business and cover investments all over the country. A venture capitalist has to travel a great deal, unfortunately.

We do find that sources of new investment occur, often largely around university and research centers, therefore we are always concerned when our States fail to keep up in the research and development activities, or especially fail to get their share of Federal funds for research and development. That often means that there will be a falling off in the availability of venture opportunities.

Senator McINTYRE. In closing, let me say that I wish there were more of you who were as successful as you have been, apparently. The other day we had an example of the problem the country has, the energy crisis. There appeared in the Washington Post, the story of an inventor, an inventor of a great deal of success. And, what ERDA, the energy R. & D. outfit agency of the Government was saying was, we do not know how to deal with one man. We are just unable to interface with you.

If you were IBM or you were Ratheon, maybe we could sit down and do business. So up in the New England area we have all kinds of budding ideas on solar energy. I would not know whether one is good or one is bad. We have all of these ideas floating around.

Mr. Dennis, you did get involved with the solar possibilities. Did you make any investments with solar energy in any form or nature?

Mr. DENNIS. We just recently made, within the last couple of months—within the last months, sir, we made an investment in the solar energy company in California. This particular company, largely related to the problems in its initial market as one of heating the swimming pools, which has been done with gas, natural gas. Its second market is going to be industrial hot water heating. It is a very small, relatively profitable enterprise.

Senator McIntre. The difficulty is somewhere out there, there may be a genius that may have an idea who is going to blush unseen.

Mr. Dennis. We as an industry, most of us, find that we have the same problem that anybody else would have in dealing with one inventor. It is very hard to finance a man, an inventor. I have done it. I have started a company where I shook hands with an inventor. He agreed to do the work, I agreed to pay all the bills. It turned out to be a highly successful enterprise, but it was a long, hard struggle.

We have recently invested in a company that was started by three doctors and a medical student. If there is any rigid rule in the venture capital business, you should never invest in something run by doctors or medical students, and yet there has to be room in our system for exceptions to rigid rules.

I guess our rigid rule, really, is there are no rigid rules in this business. You have to have the leeway, you have to have the leeway for the judgment, the gut feeling that comes into those sorts of things. This particular medical products company is going to be of great benefit to the Nation someday. It is a long way off.

Mr. Morgenthaler. That is a very good reason we said a little while ago that most of us believe that certainly the country, and probably ourselves, will benefit from the funding of additional venture partnerships if we average perhaps three or four professionals in each of our organizations.

We find it is very difficult to make a new investment per venture capital professional per year, more than one per man per year. A venture capital professional who is supervising five investments simultaneously is usually pretty busy, especially if any of the investments are in trouble. In our business, trouble is very common.

So the industry obviously has a fairly limited capacity to interface with new entrepreneurs. Most of us follow about the same ratio that has been mentioned. We would look at 100 to 150 situations from each investment that we make.

And inventors, as you say, are very time consuming and very difficult, very hard to back. Most of us break the rule occasionally and back one. We are usually sorry we did, but now and again a great company comes out of it.

We think it is a great pity there are not more organizations working in this field. We generally believe there would be enough additional good opportunities contributed that we could all invest in to make ourselves better off. There is no question that the country is not getting enough of it at this point.

Senator McIntyre. Mr. Dennis said that his background was in finance. What is your background?

Mr. Greenfield. After studying classics in college, I became a programer for IBM. I worked on computer design, self-trained, and then worked on marketing strategy for a number of years.

Mr. HANSCHEN. I was an electrical engineer and went into the marketing aspects of business. Before doing this, I was vice president of marketing for Texas Instruments in Dallas.

Mr. MORGENTHALER. Engineering, education, minor in business administration, many years of management, and self-taught finance.

Senator McINTYRE. Thank you, gentlemen.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Senator McIntyre. Gentlemen, I agree with Senator McIntyre. There should be more fellows in your business.

I remember the early fifties when you had an awful lot of venture capital deals going. I can recall in the late fifties when your broker was supposedly doing you a favor if he let you buy new issues because it was certain to go up the next day. But a year from then, a lot of it went away.

Mr. DENNIS. The business as we know it today really started with the families in New York like the Rockefellers. I think the real first institutional venture capital firm, we had to give credit to the people at American Research and Development after World War II. That is where the whole industry started from.

Senator BENTSEN. Absolutely.

Thank you very much for your appearance. We appreciate it.

[The prepared statement of Mr. Greenfield follows:]

STEWART H. GREENFIELD: THE NEGATIVE IMPACT OF ERISA ON THE FORMATION OF NEW VENTURES

In the 1950's and 1960's, a number of pension fund managers experimented with investing in young, privately held venture companies. It came to be recognized however, that investing in such companies required a much different focus and different talents than investing in large companies. Investing in large companies principally required analytic skills. Successful investing in ventures required the ability to assist the managements of the small companies in dealing with crises, the problems of sudden and major requirements for cash, the redefinition of the business strategy, replacement of inadequate management. The successful venture investors generally spend 90% of their time working with companies after the investment is made, and have a high level of operational talents. They generally do not buy an existing investment instrument, but structure, with the company management, a financial instrument that is best suited to the company's and the investor's needs. For this reason, pension fund managers turned increasingly to professionally managed venture capital funds as intermediaries to perform this kind of investing.

In the period from 1968 to 1976, an estimated 50 venture capital funds were established with substantial capital contributed by pension funds. After passage of ERISA, pension funds made virtually no investment in venture capital in 1974 and 1975, and only a minute investment was made in 1976.

This effect was unintended. In discussion with committee counsel, it appeared that the intent of Congress was to increase the rate of investment in smaller companies, through emphasis on the diversification of portfolios.

There are two aspects of the ERISA legislation that brought about these unanticipated effects.

The simpler of the two has to do with the liability of the trustee. The act charges the trustee with responsibility for the acts of those to whom he delegates investment authority, if those parties are not registered under the investment advisors act of 1940, and are not mutual funds, banks, or insurance companies. The act can be interpreted as reading that trustees investing as limited partners or minority stockholders in a venture capital fund and having no authority over the actions of such entities, are personally responsible for improper acts of those venture funds.

Trustees as a class are not bold individuals; few would be willing to expose themselves to such an, albeit remote, liability.

The second and more major problem has to do with the question of prudence. Section 404(9)(1)(B) of the act does not provide a sufficiently clear and certain standard of prudence against which venture fund investment can be measured. Counsel to investment managers hence have advised them that they are exposed to suit if the value of a venture investment declines, and they may be required to make good any losses.

To put this in perspective, we must examine how investment management firms are compensated for their services.

Typically, a large pension fund will pay a management fee of one-fourth of 1 percent of the assets under management. On this basis, if we compare situations of a 1 $million investment that doubles in size and the same investment that declines 50 percent, the gain produces income ot the management firm of $2,500, whereas the decline might cost the firm $500,000, or 200 times the potential gain.

A number of investment managers feel that the potential yields of venture investing are substantially higher than other forms of investing, and that investing one to five per cent of their portfolios in funds can contribute greatly to their performance. Others feel that it is a patriotic duty to support formative industries that help preserve America's technology leadership, and account for substantial employment growth.

However, the risks imposed by ERISA are too great, and such investment managers have not been willing to make venture investments. The result is a much lower rate of venture investment, and many fewer growth companies are being formed.

My associate and I co-managed a venture capital fund from 1970 to 1974, in behalf of an investment banking firm. A substantial portion of our funds were contributed by pension trusts. We made 36 investments in companies that have grown to employ an estimated 17,000 people and total revenues of over a billion dollars. The returns to investors, even in these difficult times, have ranged from 11% to 25% compounded annually, and will yield an estimated total of $34 million in profits. A number of the companies are highly innovative, and have made important contributions to the American economy.

On the basis of this record, we left our old firm to start a new fund. Our timing was unfortunate, as it was in mid 1974, several months prior to the passage of ERISA. We were making substantial progress towards raising a fund when the implications of ERISA became recognized, and we lost our principal potential investors. For the last three years, we have worked instead as advisors to a number of formative companies, and assisted them in solving financing problems. It is still our hope, though, to start a new fund, and passage of a remedial legislation is the key to our ability to do this.

The Bentsen Bill, S285, we see as an antidote for the consequences of the vagueness of the prudent man rule as expressed in the current act. The provisions of the law against self dealing are not affected by S285, and it is these rules that are most effective in curbing abuse of pension funds. In the case of defined benefit plans, the employer is required to make up for experience losses in the funds investments. For these plans, the principal effect of the prudent man rule therefore is not to protect the employee, but the employer, who generally has other, quite adequate devices for protecting his interests.

I therefore urge most strongly that Section 3 of S285 be enacted.

Recommendation for Amendment of ERISA To Stimulate Diversification of Pension Plan Portfolios

(By Stewart H. Greenfield)

The principal concern that led to the enactment of ERISA was to protect the beneficiaries of pension plans. One secondary interest expressed by members of Congress was to stimulate the diversification of investments from the standpoint of safety and from the standpoint of public policy. It was recognized that pension funds represent the dominant source of investment funds in the United States and that it was desirable from the standpoint of public policy that these funds be invested in young and developing corporations, as well as the very large companies that have been the dominant investments in most pension plan portfolios.

The passage of ERISA has led to a contrary effect. The rate of portfolio concentration has increased. The flow of capital into developing companies through venture funds, which had been quite large before the act was passed, has been cut off almost completely.

A review of the act reveals that this problem and a number of other burdens posed by the Act can be relieved without jeopardising the rights of beneficiaries. My analysis is as follows:

Pension funds are of two general types: Defined Contribution Plans and Defined Benefit Plans. Defined Contribution Plans require that specified amounts be provided by employers, and that the eventual yield to the beneficiaries is dependent on the subsequent management of those funds. Beneficiaries of such a plan have great concern over the quality of management of such a fund but have little influence over its management, and in this case ERISA regulations serve a very valuable function.

A second and very common form of plan is the Defined Benefits Plan. The Defined Benefits Plan is one in which the beneficiary is assured by the employer or multiple employer group that he will receive a defined future benefit, and this benefit is committed no matter what the performance is of the plan investments; should the plan be underfunded for historical reasons or experience losses, the employers are required to amortize the underfunding over a period of time.

In some cases, such plans are managed by people other than the employers. The employers have an obvious and considerable concern that the plan be well regulated yet need outside assistance such as the Act provides to assure the regulatory overview. On the other hand, most large plans are controlled by the employer.

In such cases, the fiduciary prudence paragraphs of the Act have the sole effect of protecting the employer from the misdeeds of the fund managers and fiduciaries that he selects and controls. The Act, for example, protects a company like AT&T against the imprudent acts of a major bank or fund management company. It moreover has the effect of making that fund manager focus far more strongly on minimizing his legal risks than on maintaining a diversified portfolio, and that indeed is what has happened.

I would therefore recommend that plans that are both funded and controlled by the same party and which provide defined benefits should be exempt from the fiduciary prudence sections of the Act,[1] though not against the paragraphs relating to prohibited transactions and limitations on the holding of employer securities and other provisions relating to self-dealing. (An exception of this relief should be made in the case of companies whose unfunded liabilities for their plans exceed 30 percent of their net worth, in order to protect the Pension Benefit Guarantee Corporation.)

Plans that would qualify under these provisions should also be exempted from state prudent man regulation. This proposal, if enacted, would stimulate substantially greater diversification of plan investments and help satisfy the needs of capital-starved smaller business.

[Thereupon, at 12:30 p.m., the joint hearings recessed, to reconvene at the call of the Chair.]

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[1] Art. Sec. 404(a), 405—In addition, Art 401(b)(1) should be amended to provide fiduciaries with exclusions for investments in recognized venture capital funds as it does for mutual funds. This would eliminate exposure to a fiduciary for sebsequent actions by venture funds in which the plan had made an investment.

PENSION SIMPLIFICATION AND INVESTMENT RULES

TUESDAY, MAY 24, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
OF THE COMMITTEE ON FINANCE AND THE
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittees met, pursuant to notice, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen presiding.

Present: Senator Bentsen.

Senator BENTSEN. The hearings will come to order. This morning, the Senate Finance Subcommittee on Private Pensions, which I Chair, and the Select Committee of Small Business, which is Chaired by Chairman Nelson, begin the second round of joint pension hearings on S. 901, the Pension Simplification Act, and S. 285, the Pension Investment Act.

During the first round of hearings we heard disturbing stories about unnecessary delays and costs as a result of dual enforcement of provisions of the pension reform law by the Internal Revenue Service and by the Department of Labor.

We were told that the managers of one pension plan were instructed by the IRS to follow a certain procedure only to be told by the Labor Department that the procedure was wrong and the application in question would have to be resubmitted.

What my legislation would do is divide jurisdiction between the Internal Revenue Service and the Department of Labor to try to avoid some of the overlap. Under my proposal, which follows generally the original Senate version of ERISA, the IRS would have complete jurisdiction over vesting, participation and funding requirements, while the Labor Department would be given exclusive jurisdiction over fiduciary responsibility and prohibited transactions.

Under existing law, businessmen and labor unions and others who operate private pension plans are often ordered to file one report giving information to the Labor Department and turn around to give the same information in another report to the IRS. The costs have skyrocketed; the delays have stretched out.

The cost of administering one pension plan with 19 participants rose by almost half in the year after the law went into effect. That is certainly not the intent of the Congress. Those are the kinds of things that we ought to try to correct.

It took Labor and IRS 26 months to agree on a procedure for handling exemptions for one provision in the law and 29 months after

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the law was signed, only 12 out of 600 requested exemptions have been granted.

Several changes in the statutory requirements of ERSA are needed to simplify and reduce the paperwork. Accordingly, under my legislation, the Secretary of the Treasury and the Secretary of Labor will be directed to formulate a single, annual form with a single filing date which would be filed with the Internal Revenue Service every year by pension plans.

We had Dr. Larry Woodworth testify on that point, saying that he thought that there ought to be just the one form and that particular department, the IRS, would redistribute it to other interested agencies. Different types of retirement plans.

Under my proposal, private pension plans would generally be required to file only one form annually with the Federal Government. A copy of this form would then be made available to the other departments. Separate annual pension forms by the IRS, Labor Department, and pension guaranty agency are unnecessary and impose unnecessary costs on business and unions throughout the Nation.

I am pleased to get a response from a personal conversation with the Secretary of Labor and Secretary of the Treasury who have expressed their deep interest and concern with the duplicate work and conflicting jurisdiction in their desire to try to eliminate it and direct their attention to this problem.

This morning we are fortunate to have very well-qualified individuals as the first two witnesses: Bruce Fielding, a member of the Federal Paperwork Commission and Mr. William Goldstein, Former Deputy Assistant Secretary of the Treasury for Tax Policy.

Both of these individuals have broad experience with respect to the implementation of our pension laws. We look forward to hearing their recommendations.

Mr. Fielding is a certified public accountant who helped formulate the recent report on ERISA by the Commission on Federal Paperwork.

Mr. Goldstein has provided invaluable assistance to the members of the tax writing committees, as a former Treasury Department official. We welcome Mr. Fielding and Mr. Goldstein.

I would like to insert Senator McIntyre's opening statement in the record at this point.

[The statement follows:]

Opening Statement by Senator McIntyre

The sessions today and tomorrow are a continuation of joint hearings by the Senate Finance Committee and the Senate Small Business Committee which began in February 1976.

We are focusing on Senator Bentsen's bills, S. 901 and S. 285, and are going on to explore the broad economic and social issues which are involved.

As co-chairman of the Federal Commission on Paperwork, I am particularly concerned over the dampening effects which duplicative reporting and other red tape have had in increasing the terminations and reducing the formation of retirement and pension plans. As a result, I have prepared a bill, which will be introduced this week, proposing that the remainder of the 15 recommendations made by the Paperwork Commission last December on ERISA paperwork be incorporated into the law.

STATEMENT OF BRUCE FIELDING, MEMBER OF THE COMMISSION ON FEDERAL PAPERWORK AND SECRETARY, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. FIELDING. Thank you, Senator. In addition to my duties as a member of the Commission on Federal Paperwork, I am also an officer and director of the National Federation of Independent Business which now represents 507,000 small and independent businessmen and women throughout the Nation and I am also the owner of my own accounting business.

Your bill, Senator, S. 901, the Pension Simplification Act, is of great interest to small business, because it attempts to correct a glaring defect in the Employee Retirement Income Security Act of 1974 (ERISA) dual jurisdiction. This has begat dual confusion, dual reporting, dual frustration, and multitudinous filing dates.

Whenever a business person has to cope with two or more regulatory agencies in a given area, he or she becomes a "ping-pong" ball, paddled by all until eventually becoming lost in the bureaucratic quagmire. Congress and the agencies seemed to have completely overlooked the desirability of encouraging employers to continue with their present plans or to create new ones for their employees. The only practical way of solving the social security dilemma is through the continued implementation of voluntary retirement plans. Simplification is the way to achieve this goal.

Senator Bentsen's bill is certainly a step in the right direction. Simplification by the establishment of guidelines and a clear division of authority between the Internal Revenue Service and the Department of Labor is long overdue. The bill proposes to allow IRS to continue in the same areas of retirement plan jurisdiction it has had for years—participation, vesting, and funding—and to make DOL responsible for prohibited transactions and their related problems. We find this concept preferable to recently proposed legislation which would create a new agency to have sole responsibility in these same areas.

However, we would like to offer the following suggestions which we feel would greatly enhance the premise that Congress should encourage, through simplification, private voluntary retirement plans:

The proposed amendment to section 103 of ERISA should make a distinction between plans with less than 100 participants and large plans and should specify the information required of these small plans. The proposed language leaves too much up to the imagination of the respective agencies and does not instruct them that they should consider the different requirements for large and small plans. For example, the annual small plan report should be designed so that a copy could be given to the participants. One report for all should be sufficient. Whenever the vague expression, "such reports as he determines are necessary" is used, the door is wide open for a bureaucratic flood of paperwork.

Even though S. 901, section 6, specifies that there shall be a single annual form, the latitude allowed in the proposed amended section 103, could nullify this simplicity. The result could be a one-page report accompanied by tons of schedules.

Also, it may not help the present duplicative requirement of filing the form EBS-1 with DOL and form 5300 with IRS. In the case of prototype plans, a copy of the adoption agreement should be sufficient for all concerned parties, including the participants.

We also feel that the 60-day gestation period for the proposed annual form is not realistic. Forms which are begat before regulations are promulgated are sometimes worthless. We would prefer that S. 901 specify that this act would become effective 60 days after regulations are finalized and that IRS and DOL must finalize these regulations within 90 days after enactment.

Senator BENTSEN. Do you think it is realistic for them to get all of their regulations promulgated 90 days after enactment?

Mr. FIELDING. Senator, that is a very good question. Having never written regulations, I am a great authority on them. I would say if we do not give them deadlines, we will have the results that we have now. Ninety days may be much too short; perhaps it should be 180 days, but without guidelines and deadlines, we will go on as we are now.

Senator BENTSEN. Let me see if I understand your other point about section 6 where I call for a single, annual form. You say that the latitude allowed in the amendment nullified the objective of simplicity. What did you mean?

Mr. FIELDING. What I was referring back to was 103, where we do say "such reports as he determines necessary."

Senator BENTSEN. I see. Please proceed.

Mr. FIELDING. The next area is in the area of declaratory relief. Here is another example of Congress failure to understand the difference between large plans and small plans. A small employer is not going to go to the expense of getting a determination letter from a Federal court. What is needed is relief from the requirement of obtaining a formal determination letter for small plans.

For example, a master or prototype plan should be deemed approved without having to get a formal IRS determination letter.

Senator BENTSEN. Is that a case where you are automatically disqualified?

Mr. FIELDING. Until you prove otherwise.

Senator BENTSEN. All right.

Mr. FIELDING. For example, a master or prototype plan should be deemed approved without having to get a formal IRS determination letter. Also, certain plan investments should be exempt from the necessity of getting a determination letter, if they need specified guidelines: (*a*) loans to employers of up to $200,000 should be allowed if secured, loan interest at market rate, are payable in equal installments not to exceed 20 years, and do not exceed 75 percent of the value of security; (*b*) rental of assets to employer should be allowed if rent is fair according to an independent appraiser. Large plans are now in effect exempt from these investment restrictions because of the geographical dispersion and marketability rules.

A single flexible master or prototype retirement plan should be an alternative to the present variety of plans—defined benefit, money purchase, target benefit, profit sharing, Keogh. Basically, it would be a corporate profit sharing plan which allows contributions to be allocated as at present or as a percentage of wages weighted by age.

This universal retirement plan would allow small businesses to create plans similar to those now permitted for large businesses but without costly paperwork burdens and the obligations to make fixed contributions and to fund investment losses. Substantial savings would result from the elimination of the need to incorporate, appoint a bank trustee, prepare actuarial computations, administer multiple plans, and file multiple reports.

In addition to the aforementioned simplification suggestions, we would also like to recommend the mandatory creation of a small business retirement plan advisory committee which would act in an advisory capacity to both IRS and DOL. We believe that a single citizens' advisory committee would insure cooperation and communication between the two agencies.

Several months ago, the Commission on Federal Paperwork issued a "Special Study Report on ERISA" which contained 14 specific recommendations for the reduction of the reporting burdens imposed by IRS and DOL. Many of the recommendations have been or are in the process of being implemented by IRS and some of the recommendations will become law if S. 901 is enacted. Accordingly, we urge that those recommendations upon which no action has been taken be given further consideration by Congress, IRS, and DOL.

We understand Senator McIntyre is going to introduce amendments today that will recommend the balance of our recommendations.

Senator BENTSEN. I thought that those that were not put in S. 901 would be taken care of administratively.

Mr. FIELDING. They have not been implemented. It does require a push by Congress to get them implemented.

Senator BENTSEN. When you talk about a master or prototype plan, as opposed to a target benefit and all of the others, you are talking about prospectively, in the future, not talking about going back and changing the plans in being, are you?

Mr. FIELDING. No. I am talking about the future, not compulsory, but an option to adopt a universal plan.

Senator BENTSEN. All right. Even in the future.

Mr. FIELDING. Yes.

Senator BENTSEN. I see.

Mr. FIELDING. As a practical matter——

Senator BENTSEN. I would agree with you on that basis. I thought you were trying to force them all in one boat.

Mr. FIELDING. No. This would be an option which would be utilized by your small employers. As I say, they are not that sophisticated. They do not need all of the fancy frills that we have in the law now to benefit their employees.

I think, Senator Bentsen, you are certainly to be commended for taking the leadership in simplification of a very complicated section of the law, and I think it is very gratifying to see that you have had the foresight to set forth the simplification suggestions that you have in your bill, and they will be extremely helpful to small business.

Senator BENTSEN. I appreciate all that, but now we have to see the implementation of it.

Mr. FIELDING. Thank you.

Senator BENTSEN. Mr. Goldstein?

STATEMENT OF WILLIAM GOLDSTEIN, FORMER DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. GOLDSTEIN. Good morning.

I am pleased to testify before you today with regard to S. 901 and S. 285, two bills which address important questions pertaining to our private pension plan system. I make no pretense of being an expert with regard to ERISA and the issues thereunder, but in 15 years of the private practice of law, I have had to deal with pension problems from time to time and particularly with those of smaller companies.

In addition, during my service last year as Deputy Assistant Secretary of the Treasury for Tax Policy, I became familiar with the overlapping jurisdiction of the Treasury Department and the Department of Labor with regard to ERISA and with the complexities which this dual jurisdiction produced, particularly in the area of promulgating regulations.

In that connection, the first ERISA problem I saw upon returning to private practice was an example where the statute seemed to be clear. The issue involved a profit-sharing plan that had most of its assets concentrated in the employer's stock. The stock was marketable and was at an all-time high; the trustees and the members of the plan and everyone thought that it would be particularly desirable to have that stock repurchased by the company.

However, there were no regulations in point, and to get some guidance, of course, you make telephone calls to people you know at IRS, Treasury, and Labor and find each one deferring to the others and saying that it looks all right, but it is very risky to proceed in the absence of regulations.

Of course, this was 3 years after the bill had been enacted, the market for any public security may not hold. We proceeded to write an opinion letter, got an opinion letter from another law firm and proceeded with the transaction. Given the penalties in present law for making mistakes, it is a very scary proposition.

Another fairly graphic example——

Senator BENTSEN. The easiest thing is to do nothing.

Mr. GOLDSTEIN. Yes. This is a case where everybody wanted to do the transaction. If you are sitting there as a trustee, you get very sweaty palms. I was sympathetic to them. Even for a law firm writing an opinion letter, it is a nervous time.

Another example in a smaller situation, one of my corporate clients before I left to work for the Government had already filed its papers to qualify, for the first time, a profit-sharing plan under section 401.

When I returned to the firm in January of this year, the papers were still being processed and it has only been within the past few weeks that the qualification ruling has finally been received. Even then it was conditioned on some further amendments to the plan. This is a small business, by any definition. It has sales of approximately $2.5 million and 70 employees. It has already had to spend over $10,000 in legal and related costs in developing and processing the plan. It has not gotten into the form-filing yet; this is just to get started.

There was an amendment in the middle of this process designed to give employees the option to exempt themselves from coverage. Notify-ing everybody you had to notify about that amendment caused untold complications and at least 6 months of delay.

Finally, and I think this is the most discouraging part, now that the initial work has been completed, the company has been so discouraged with the process that it is seriously considering terminating the plan before it really becomes operative.

S. 901 attempts to deal with some of the serious problems of dual jurisdiction by dividing the responsibility for the various parts of ERISA between the Department of Labor and the Treasury Department. The portions of S. 901 which deal with this subject should be compared in style and approach to H.R. 4340 which purports to deal with the same problems by creating an entirely new agency independent of both Treasury and Labor. As between the two approaches, that of S. 901 seems superior in terms of simplicity, rapid effectiveness and political reality.

I note that former Commissioner Alexander recently testified before you in support of S. 901. In general, I would like to associate myself with his favorable comments. In addition, however, I would like to raise several questions for your consideration.

For example, when bill section 2(a) removes from the Department of Labor all jurisdiction over participation, vesting and funding, it appears that these matters are to be dealt with by the Internal Revenue Service under code sections 410, 411, and 412.

The latter sections, however, deal only with plans qualified under section 401(a), whereas present sections 202, 203, and 204 of ERISA, even though limited by section 201, also cover certain important categories of nonqualified plans. It would thus appear that these nonqualified plans would no longer be subject to regulation in these areas, and the new powers given to the Secretary of the Treasury under section 5 of the bill would not appear to fill this gap.

Assuming that this lapse of coverage is unintentional, the bill should be amended to provide for coverage under the jurisdiction either of the Department of Labor or the Internal Revenue Service. Choosing Labor seems inconsistent with the general policy of transferring these issues solely to IRS, but it should be noted that the Service has not had extensive experience in dealing with these nonqualified plans—that is, the tax issues presented thereby are relatively uncomplicated.

Turning to the subject of prohibited transactions, I am satisfied that these matters are best dealt with by a single agency and that such agency should be the Department of Labor. I question, however, how well new section 3004(c) of ERISA would function. Under such section, agents of the Internal Revenue Service would be required to notify the Department of Labor and the Department of Justice of possible prohibited transactions uncovered in the course of their audits.

Is it intended that this be the sole method of discovering such transactions, or is the Department of Labor to have its own agents for this purpose?

If the IRS is to be principally relied upon, I question the efficacy of such a program where the agents already have a heavy workload and, as a practical matter, will get no "credit" for this work. On the other hand, if the Labor Department is to police this field itself, a new bureaucracy with branches in many districts would have to be created.

Furthermore, since the Service will continue to possess the ultimate power to disqualify a plan under the "exclusive benefit" test, it may, on occasion, second-guess the Department of Labor with regard to the seriousness of violations, and even with regard to transactions as to which Labor has granted an exemption.

Indeed, if the Service feels frustrated by Labor's handling of prohibited transaction matters in general, or in a particular case, it will be left with the sole remedy of disqualification—one of the circumstances which ERISA sought to overcome.

Senator BENTSEN. You pose a problem. What is the solution? We also are talking about the political realities.

Mr. GOLDSTEIN. Since I have written this, I have reflected on what I would try to do. At the outset, I think it would involve some coordination at the top levels, particularly in the IRS, to make it clear that it is a responsibility which agents have, equal to any other responsibility for which they would be given credit. They must identify the situation. That is clearly an internal administrative matter.

If the two agencies go along with the spirit of division, that ought to work.

Furthermore, I think that a rule could be promulgated—I do not know if it needs to be in the bill or not—that a disqualification proceeding could not proceed until Labor had first been given the opportunity to attempt to remedy the prohibited transactions in question.

It is not an easy question. It is easier to ask than answer, but we should look at it.

I would like to express my strong support for the provisions in S. 901 which prescribe a single form and single annual filing date for certain reports required under ERISA. As outlined in the report of the Commission on Federal Paperwork of December 3, 1976, the paperwork burden under ERISA is intolerable and any meaningful steps to reduce this burden should be taken.

It has been suggested by the Internal Revenue Service, among others, that much the same effect could be achieved by voluntary action on the part of the concerned agencies by waiving certain reports and consolidating others. While this may be so, I would support the statutory solution to be sure that the result is accomplished in the speediest possible fashion.

Senator BENTSEN. I agree with that, and I will tell you one of the reasons why I think you have to go that way. No one in an agency likes to say we can deal with that report, and then have something come up that would have been taken care of by that report and be blamed for it.

If they had a statutory requirement to limit it, they would go along with it and say the Congress did that.

Mr. GOLDSTEIN. When you are dealing with bureaucrats, you are dealing with human beings. Two fellows who see eye to eye today may not see eye to eye tomorrow.

Section 7 of S. 901 purports to extend the declaratory judgment remedy to any failure by the Secretary of Labor, the Secretary of the Treasury or PBGC to issue or deny a determination or ruling or to take any other action with respect to an employee benefit plan within 180 days of the request for action.

In my view, particularly in the case of a smaller company, such remedy may prove illusory. This is because litigation is extremely expensive and hoped-for expedition may not occur due to the great amount of time consumed in the judicial process itself.

Needless to say, since the Government is, of necessity, the defendant in any of these actions, if they are motivated to go slow, they have an infinite variety of ways to slow down, both legitimate and not so legitimate, to slow down the course of litigation.

If Congress really desires prompt action, I would suggest that the requested action be deemed to have been favorably taken if the request is not acted upon within some specific time period. If this rule is considered too harsh, a time period in excess of 180 days might be provided; the requested action could be deemed effective for a period of 1 year only unless no response is forthcoming within that year; and/or the Government agency in question might be permitted additional time to rule if it issued a certificate within the time period that the action is being held up for significant policy reasons.

I am suggesting a series of gradations of what you would do to give relief if the administrators come in and say this is too tough. I think I would give serious attention to the time period to try to come up with something fair. I think I would put the 1-year presumption in. I think I would wait and see before I would go to the certificate procedure, or whatever, because if you make it so easy to issue a certificate that it becomes routine, you have not accomplished anything.

A final point pertains to the scope of section 3002(e) or ERISA, as amended by section 5 of S. 901. In your floor statement, Senator, you stated that:

> Under my proposal, the Internal Revenue Service would be given flexible enforcement powers such as excise tax powers and general equitable remedies to enable IRS to enforce the vesting, funding, and participation standards in such a way as to best protect the rights of pension plan participants and beneficiaries.

Section 3002(e) would appear to give the general equitable remedies to which you refer, but I do not believe that the Secretary of the Treasury would be empowered to impose excise taxes on account of violations of the vesting or participation standards, as opposed to the excise tax powers for funding violations which already exist. It would appear, however, that equitable enforcement would be sufficient in the case of vesting and participation.

In other words, I think the bill is all right the way it is.

In summary, I conclude that S. 901 is definitely a step in the right direction of reducing the complexities and delay in administration of ERISA and in reducing the paperwork burden resulting therefrom. As I have indicated, however, there are still some important questions to be resolved, and I believe that these hearings will give rise to amendments which could prove quite helpful.

Turning to section 2 of S. 285, I really feel somewhat beyond my depth in dealing with the issues presented thereby. First of all, it seems clear, given my earlier support for S. 901 and its proposed repeal of code section 4975, that it would be inconsistent to create a new section 4976 imposing a similar excise tax on excess investments. Also, since section 2 of the bill deals with activities more closely related to prohibited transactions than to vesting, participation and funding, I would suggest that the Department of Labor should have jurisdiction over enforcing any new policies in this area.

More importantly, however, I am in general agreement with Dr. Woodworth that the subjects of trading power and concentrated ownership go well beyond ERISA considerations and should, perhaps, be regulated by the SEC rather than either Treasury or Labor. While I concede that special tax subsidies granted to certain pension plans may justify greater regulation, and also that there is an element of beneficiary protection through promoting diversification, the issues presented still strike me as too broad for treatment solely in the context of ERISA.

With regard to the proposed modification of the prudent man rule in section 3 of S. 285, I should first note that I am as strong an advocate as you could find for encouraging venture capital and investment in smaller companies. I do not, however, believe that the way to accomplish this is by encouraging fiduciaries to be less than prudent with even 2 percent of the assets upon which employees rely for their pensions. Rather, I would prefer to see other incentives for smaller companies, both inside and outside the tax law, so that investments in such businesses can be made by pension funds because they are indeed prudent.

Thank you for hearing my views.

Senator BENTSEN. Thank you very much.

One problem you run into in the investment of pension funds is the application of the prudent man rule. Very able lawyers differ as to the interpretation of that prudent man rule. When you get that kind of a difference of opinion, the natural reaction on the part of a lot of pension managers is, all right, we will just invest in the very large companies so that no one will criticize us.

If a manager invests in something like IBM or General Motors and it goes down the tube, who can criticze them? Who can criticize them for it? But if they go into a small company that no one ever heard of, then there is a lot of second-guessing that takes place.

The general reaction on the part of a lot of these people is, let's stay with the big people and let the very largest of the financial institutions handle these things. That is the safest way to proceed.

We really do not want this problem anyway. We have just divorced ourselves from it.

We had a lot of people from venture capital companies who came up here, of course, and testified that pension funds were a source of venture capital until ERISA came along and they cited numbers, the kind of funds they were getting for venture capital.

Insurance companies traditionally have a basket clause, maybe 1 percent, 3 percent, 5 percent, depending on the State. You have over 1,500 different companies listed on the New York Stock Exchange. You are not talking about an onerous limitations as far as investments.

I think that there is an inherent danger for the beneficiaries of these pension funds if you see an overconcentration. I think you need a spread. I am talking about two things: A limitation of stock ownership, and the modification of the prudent man rule.

Talking about other incentives for encouraging venture capital situations, I am quite interested in finding other ways of doing it. I do not negate the possibility. However, because of the concern over the interpretation of the prudent man rule the easiest thing for a pension manager is to leave those small companies alone.

Mr. GOLDSTEIN. A suggestion I would make, dealing with both points covered in the bill, is that in regulations or pronouncements or whatever, the relevant departments could state that it can be imprudent to concentrate in a large company and it can be prudent to invest in a small company below your $25 million standard.

I guess what troubles me most about the way this particular bill is set up is that it appears to give a license to be imprudent, to be able to make your investment in a smaller company without any regard for safety. You should not do that. As a trustee, the most important thing, obviously, is maintenance of principal and growth.

Senator BENTSEN. I prefer the interpretation that you look at the entire portfolio and determine whether you have been prudent or not. That just happens to be my preference. There are some other people who say that is the way it ought to be. That is the approach.

I can sure cite you a lot of witnesses who will argue the other side, that is when trustees and managers of portfolios decide the way to do it is just to take the big one.

Mr. GOLDSTEIN. I could not agree with you more, that that is, in fact, what happens.

Another thing which concerns me—I think it was Senate Finance last year—where we heard testimony that pension funds should be required to invest some portion, some very significant portion, like 10, 20 percent of their assets in residential housing and so on.

Senator BENTSEN. Once you go to that kind of directing, you run into problems and you violate the protection and security of the beneficiary.

Mr. GOLDSTEIN. There is no suggestion that they were not to be good investments, however. Those statutes set forth a lot of things that are clearly all right for insurance companies and mutual funds and then allow them to have miscellaneous investments up to some percent.

I do not know. Maybe it is a question of degree or style as to how you phrase it.

I agree with your suggestion that you look at the entire portfolio in making an evaluation.

Senator BENTSEN. I am afraid that what a court is going to say is, why did you go into that company when it went broke.

Mr. FIELDING. I do not think we should necessarily accept the fact that it follows that if you waive the prudent man rule, everybody becomes imprudent. I do not think that is the case. You get the overreaction.

Take our federation, which represents small businesses all over the country, the largest organization of its kind. Our employee plan, the assets in our plan, we overreacted to it, so we will not go into anything less than AA bonds. Here we are, representing small business but we are not going to invest in small business.

Senator BENTSEN. That does not make any sense.

Mr. FIELDING. No, it does not.

If I might say as an aside, not on the subject matter this morning, I really would like to take this opportunity, Senator, on behalf of our 507,000 members to congratulate you on the fine work and support you gave to the tax credit. Without your help, we may not have had an employment tax credit.

Senator BENTSEN. I hope you fellows use it, so we can prove that it works. That is the proof of the pudding.

Mr. FIELDING. It is our job to publicize the benefits.

Mr. GOLDSTEIN. I have to go back to my office and figure it out. It is mind-boggling.

Senator BENTSEN. One of the pension proposals, of course, is that we create a new agency to handle all of this. We have had some earlier testimony stating that if we do that, we really are going to give business a problem. It is going to take at least another year, even if they transfer people out of the Department of Labor and out of the IRS into a new agency, while they fight for their turf and their jurisdictions and find their space and the corner window and all of that sort of thing, that you are really going to throw these plans into further turmoil. Would you agree?

Mr. FIELDING. Absolutely.

I think it would set ERISA back several years if we do the separate agency.

Senator BENTSEN. Do you have any comment, Mr. Goldstein?

Mr. GOLDSTEIN. In my statement, I stated that I agreed with what you just said, based upon my limited experience in government. You are talking about several years of delay. We would be almost back where we started 3 years ago.

It is a lot easier to take functions away and split them, as your bill recommends, than to try to put a new agency together. The battles over who is going to be whose secretary would be mind-boggling.

Senator BENTSEN. Thank you very much, gentlemen.

Mr. Stults, Mr. Walter B. Stults, executive vice president, National Association of Small Business Investment Companies. We are very pleased to have you and look forward to your testimony.

STATEMENT OF WALTER B. STULTS, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. STULTS. Thank you, Mr. Chairman.

Your observations to Mr. Goldstein just about summarize my whole statement, but probably the point is important enough that I should reiterate it.

Senator BENTSEN. If they are in concurrence with my ideas, I would be glad to have you go over it.

Mr. STULTS. Yes, sir.

NASBIC represents over two-thirds of the SBIC's and MESBIC's. Its members account for approximately 90 percent of the billion dollars of assets in the SBIC industry today.

I shall confine my statement to section 3 of S. 285, the section which deals with the prudent man rule.

I conclude that ERISA has had a serious adverse impact on small business. In common with every other witness who has appeared before you, I fully endorse the overall goals of ERISA as it was passed in 1974. On the other hand, both the language of the act and its ramifications have brought forth severe dislocations. I am certain these results were not intended by Congress, so we trust that Congress will alleviate the evils promptly.

Specifically, I speak of the "prudent man" rule which became part of the Federal Code when ERISA was enacted. The consequence of that action was to shut off almost completely any investment by pension funds in the securities of small or medium-sized businesses—and in the securities of SBIC's and other venture capital companies.

On May 11, your committees heard from a panel of four highly qualified and articulate spokesmen for the National Venture Capital Association. I endorse every word in their statements and believe that their answers to questions posed by Senator McIntyre illuminated several important aspects of the problem.

The NASBIC witnesses spoke of the desirability of utilizing a cost factor as opposed to value in coming up with a 2 percent; if you have a real winner you may very well get out of your 2-percent basket.

The second point, I notice in section 3 you talk about capitalization of a business with less than $25 million. Without studying it, I wonder if that would still not leave a vast no man's land between $25 million and the billion dollar corporations that are in the Fortune 500. That is just a question. I have not had a chance to research it. I would like to do it, and go back to staff, if I may, to see if that does leave out a number of very sound businesses which would be prudent investments but would be outside the Bentsen basket.

Mr. Chairman, I would also like to call to your attention the fact that Secretary Bill Simon last year talked about—he formed a Small Business Advisory Committee on Economic Policy. In its final report, submitted to Bill Simon in December, the Advisory Committee said that it felt that the prudent man rule has been extremely harmful, and should be corrected either by statutory amendment or by executive branch cooperation between the Treasury and Labor Departments. Fiduciaries responsible for investing $210 million in pension funds should be told that small business investments are as permissible and acceptable as any others within the prudent man rule.

I was interested to hear that Mr. Goldstein seemed to agree with that in answer to your question, but last year, Secretary Simon said he did not believe that the Treasury Department ought to get involved in issuing such a statement.

I have understood that Larry Woodworth told the National Venture Capital Association that he did not believe that the Treasury Department under this administration ought to get involved by issuing such a statement, either. It seems to me quite clear that legislation is the only way out.

The National Venture Capital Association itself issued a report at the end of last year in which it urged that there be incentives given to encourage investments in innovative companies and venture capital pools by pension funds, and finally the Casey task force report, a blue ribbon group that was set up by SBA Administrator Kobelinski last spring filed its report in January 1977 and urged that ERISA be amended to declare a policy that pension funds may invest in a broad spectrum of American companies within the prudent man rule and that the rule applies to the total portfolio rather than any individual investment.

The Casey task force also urged a 5-percent basket. The Bentsen bill, S. 285, has a 2 percent. It seems, indeed, a modest step in the right direction and certainly should not raise any criticism, although last week Larry Woodworth did tell your committee that it was a poor idea.

As to Mr. Goldstein today, it seemed to be a straight progression. If it is not prudent—even though that word is in quotes—it must be imprudent. We reject that completely.

Let me expand slightly. I believe that a prudent investment has both a positive and a negative aspect. On the positive side, an investment in the venture capital pool is not necessarily imprudent. As a matter of fact, many professional SBIC and venture capital company managers have been extremely successful in compiling admirable rates of asset growth over long periods of time. By avoiding disastrous losses and by choosing portfolio companies with good management and good growth prospects, these venture capitalists have chalked up investment records which far outpace the Dow-Jones or the Standard & Poor's 500.

On the negative side, an investment in a Fortune 500 firm is not necessarily "prudent" just because the securities have been issued by a corporate giant. Businesses grow old, too, so I maintain that an investment adviser who constructs a portfolio consisting only of "mature" companies stands a high risk of hanging on to a bunch of senile securities as the years go by.

Parenthetically, I would like to ask perhaps that the committee staff ask the Library of Congress to check the Fortune 500 list for 1952 and compare it with the 1977 list. How many of those companies did not make it? How many prudent investments of 25 years ago, because they were a part of the Fortune 500, right now would not look so good?

Senator BENTSEN. It sounds like you had some Studebaker stock.

Mr. STULTS. I have had some losers.

Second, is the leeway given by S. 285 mandatory? Certainly not; it is permissive. If the pension manager does not wish to invest in any venture capital funds or in any growth stocks, he will not be forced to by the Bentsen bill.

Is this a new concept? Not at all. In most States, insurance companies, for example, are given a "basket" of 5 percent, which they can invest in securities which are outside the ordinary, conservative range of investments. We have heard no protests against that long-time practice.

Are the present strict rules good for the Nation? We answer with an emphatic "No." Pension trustees now hold about $450 billion in funds, we find, with the total growing by leaps and bounds every year. To say that this enormous source of capital must be ruled off limits for those who invest in the birth and growth of independent businesses is to deny the fundamental basis of the American free enterprise system.

Let me say again that we are not advocating wild-eyed, high-risk investments in crazy concepts. Dollars assigned to venture capital pools can be just as "prudent" as those placed in stocks of the triple-A's. Therefore, I conclude that the Bentsen bill can be good for both the beneficiaries of the pension plan—and for the national welfare.

I must say that I was disappointed in the Treasury testimony on S. 285 which opposed section 3. The Department seemed to take the easy way out by arguing that the only alternative to "prudent man" is "imprudence." Specifically, Dr. Woodworth said last week that "the prudent man rule has served to protect beneficiaries from imprudent actions by plan administrators."

That is just too simplistic. There is clear evidence before your committee that ERISA cut off even the slow trickle of pension dollars which went into venture capital prior to 1974. We had hoped that the executive branch would work with the Congress in remedying this unintended impact of ERISA. Capitol Hill must do the job alone, it appears.

We pledge our support to advance S. 285 to final approval.

Thank you.

Senator BENTSEN. Thank you very much, Mr. Stults.

I think that what you are pointing out is that you can get a simplistic reaction when you talk about making an excepion to something. The concept of a leeway clause is not really a new idea. It has been used, I am sure, for at least 50 years with the insurance industry.

I operated on that very limitation with an insurance company. We had no problems with that at all. That company was about 60 years old at the time, as I recall.

I appreciate very much your testimony.

Our next witness is Mr. William C. Spencer, president of the American Society of Pension Actuaries.

STATEMENT OF WILLIAM C. SPENCER, PRESIDENT, AMERICAN SOCIETY OF PENSION ACTUARIES; ACCOMPANIED BY JIM NASH, EXECUTIVE DIRECTOR AND COUNSEL FOR THE SOCIETY

Mr. SPENCER. Good morning, Senator. My name is William C. Spencer. I am an enrolled actuary and president of the American Society of Pension Actuaries. Also present is Mr. Jim Nash who is the executive director and counsel for the society.

We appreciate the opportunity to appear today and endorse S. 901, the Pension Simplification Act, as well as to comment on its provisions in behalf of our membership. We feel that S. 901 represents an important step and significant interim solution to some of the serious problems facing the private pension system.

The American Society of Pension Actuaries is a national professional society of plan actuaries and consultants. Our members provide consulting, actuarial, and administrative services to a major portion of all qualified plans, including a substantial percentage of the smaller plans in the United States. As you know, recent statistical data indicate that 96 percent of all plans have less than 100 participants. In our statement we will comment on the need for S. 901 and its provisions, as well as offer suggestions of additional areas which should be included in a final version of the bill.

With respect to the impact of ERISA on the number of plans. The experience of our members indicates that ERISA has adversely affected the private pension system with respect to continuation of existing as well as the establishment of new plans. The fact that plan terminations have greatly increased and plan initiations have greatly decreased is a matter of serious concern.

Senator BENTSEN. Where do you find the most serious effect? I would assume it is on the smaller pension plans; is that correct?

Mr. SPENCER. Absolutely. As I go further into my statement, I am going to bring out some points with respect to the cost factors. This is really where ERISA has had its most dramatic effect.

A recent report issued by the Congressional Research Service shows that since the passage of ERISA the ratio of new plans to terminated plans has gone from 14.4 to 1 down to 1.2 to 1. This data indicates that there presently is serious trouble in the private pension system.

The major reason for the great number of terminations and considerable reluctance of employers to initiate new plans is cost. Not only do the vesting, funding, and other substantive provisions of the act serve to increase costs, but the new very burdensome reporting and disclosure requirements have resulted in significant increases in administrative costs.

We have previously submitted testimony to this committee with respect to the increase in plan costs in February 1976. The factors which affect the ultimate cost of a pension plan are (1) the amount of benefits to be paid, (2) expenses to be paid, and (3) investment income received. The formula for determining the ultimate cost is to take the benefits paid plus administrative expenses and deduct investment income.

There are a number of sources which have increased plan cost under ERISA:

(1) Increased recordkeeping—to meet minimum standards;

(2) General administration—employer notification and communications requirements;

(3) Accounting audit;

(4) Actuarial—funding standards—accounting requirements;

(5) Legal—plan amendments, fiduciary responsibilities, prohibited transactions;

(6) Investment management—fiduciary responsibility;

(7) Reporting and disclosure—IRS, DOL, PBGC; and

(8) Regulatory delays—without regulations, plans have to be amended repeatedly.

We are convinced that, regardless of the reasons indicated by employers for plan terminations, ERISA is a major cause. Because of the requirement that a plan be permanent when established, the Internal Revenue Service theoretically only permits termination on a tax-qualified basis in cases of business necessity. We doubt quite seriously that any available statistics provided by administrative agencies accurately reflect the actual extent to which ERISA has caused plan terminations. That is because employers are reluctant to state that the real reason that they are terminating their plan is because they do not wish to comply with the burdens of ERISA.

Instead, business necessity is usually given as a reason except in unusual cases such as change of ownership or business liquidation. It is obvious at this point that the business owner is actually concerned about a loss of a past year's tax deduction or about being required to reallocate plan assets in a detrimental manner.

Therefore, we believe ERISA has had an adverse impact on the private pension system, especially with regard to small employers. However, much can be done to remedy this situation, at least on a short-term basis, if legislation such as S. 901 is enacted into law.

S. 901 will do much to relieve the present regulatory confusion which surrounds two critical areas: minimum standards and prohibited transactions. However, it will only constitute an interim step in the process of solving the multiple jurisdiction problem which now works against the efficient and orderly operation of retirement plans. It is clear that overlapping jurisdiction in the administration of ERISA caused unnecessary expense and inconvenience to employers and it has served the interest of plan participants quite poorly.

Since employers have been overwhelmed by the massive paperwork and lack of regulatory guidance under the present system, they have been unable to make rational decisions about the initiation and operation of plans. One result has been the upsurge in plan terminations; another has been a decrease in the number of new plans. We feel that S. 901, if enacted, will provide an effective short-term solution to the problem but that more drastic measures must be taken if the private pension system is going to continue to expand at a rate necessary to meet the needs of the American public.

The only satisfactory long-term approach is total consolidation of the pension regulatory process. We are certain that S. 901 will provide short-term relief but do not feel that temporary relief will continue to permit the private pension system to expand as rapidly as it must in the future. The establishment of a single regulatory agency with total responsibility for all regulation of private plans is the only satisfactory long-term solution to the problem of providing a regulatory framework which will contribute to the expansion of plans at a rate sufficient to meet the needs of workers in the future.

Senator BENTSEN. Let me say that in our first round of hearings, Assistant Secretary of the Treasury Woodworth and the former Commissioner of Internal Revenue said that if a new pension agency were established, there would still be a significant overlap of IRS even with the new agency. For example, IRS would still look at the deductibility of pension contributions as a part of business tax audits for reasonable compensation.

Even with the new agency, you are not going to get away from this duplicate jurisdiction. In addition, we have heard this testimony this morning and heard it the other day, about the kind of hiatus we have in transferring employees to a new agency over for a period of time.

Mr. SPENCER. Senator, we testified before the House Labor Committee on their bill. One of the things we pointed out was that we did not think that their bill would solve the short-term problems since it would be too late by the time their bill could ever, with a 1-year delay they have included in it, be put into effect, before 1980.

1980 is going to be much too late to solve the problem. It is our feeling that, if an administrative agency, a separate agency, an ultimately long-term agency, was established and it was given the authority within the law, so that the Internal Revenue Service would have to accept their determination with respect to qualification, that this would be a much better solution for the private pension system.

Senator BENTSEN. When the IRS is doing an audit, looking for reasonable compensation, for example, they would still be doing that, would they not?

Mr. SPENCER. That is true. I guess it is inevitable. You are going to have a certain amount of overlay of responsibility between the revenue aspects and operation of the private plan. To the extent a single agency might minimize the amount of overlap, I think it should be accomplished.

Senator BENTSEN. Please proceed.

Mr. SPENCER. I think you have to look at it from the standpoint of the small employer. The more agencies he has to deal with, the more frustrating it becomes. While there may still be some overlap, even under the single agency scheme, I think that in the long term, it would be much more desirable.

The reporting requirements of ERISA have been a continuing source of expense and irritation for employers. S. 901, however, calls for several steps which simplify ERISA reporting requirements. We agree that the addition of these provisions will eliminate some of the needless duplication of effort and increase employer receptiveness to retirement plans.

We also feel that the declaratory judgment provisions of S. 901 are of significant potential value. These provisions will make the entire regulatory process more responsive to the needs of plans and their participants.

Since S. 901 raises the question of whether ERISA has not, in some respect, operated to the detriment of the private pension system, we would like to see the bill enhanced through the addition of provisions designed to solve some of the other serious problems employers have experienced since the passage of the act:

With respect to the problem of "four-forty" vesting. Considerable attention was directed during 1975 to the implications of revenue procedure 75-49 requiring so-called "four-forty vesting" for certain plans, but no solution has yet appeared.

The effect of this procedure is to require that many new plans, especially those initiated by small firms, must use a vesting schedule which is not only more costly than those provided in ERISA, but which carries with it a prohibition against the exclusion for vesting purposes of years of service prior to initiation of the plan.

The exclusion of such years is specifically permitted by ERISA. We believe that this practice is not only contrary to ERISA but is also a great deterrent to the initiation of new plans.

With respect to salary reduction plans. Another cause of the current low rate of plan initiations may be the continued freeze on the establishment of new salary reduction plans. ERISA contains a provision permitting the continuation of existing plans of this type, but new salary reduction plans cannot at present be established. Accordingly, a rational and effective means of providing benefit to employees is unavailable to employers contemplating establishment of a plan.

The restrictions on new salary reduction plans should be eliminated at least until Congress reexamines this area and provides fair and rational rules for everyone. There is no fairness in continuing old plans and denying the same benefits to new plans. When these rules are reexamined, we feel strongly that they should permit salary reduction plans for everyone. This would do more for encouraging the adoption of new plans by small employers than any other possible action.

With respect to the eligibility rules. The requirement of ERISA that all employees be brought into a plan within 6 months of completing 1 year of service is a major deterrent to small employers considering the initiation of a plan. Furthermore, the rule has little practical value to participants, especially in regard to defined benefit plans.

With respect to the hour of service rules. Present rules are complex and difficult to understand, especially for small businessmen. Congress should take steps to simplify these rules.

Reporting and disclosure. As we have said, the provision of S. 901 simplifying the reporting requirements will be most helpful. The Commission on Paperwork in its report on ERISA on December 1, 1976, made a number of other recommendations which we feel should be seriously considered for inclusion in this bill. The Commission worked long and hard on its recommendations, all of which would help simplify the difficulties of small employers in operating retirement plans.

In summary, we feel that S. 901 should be enacted as soon as possible. We also feel that prior to enactment it should be modified to solve still other problems of critical importance to employers. We have previously said that we believe the best long-term solution to the problem of administering ERISA is the establishment of a single, independent administrative agency, and we still hold to this view. However, S. 901 is an important step in the right direction.

Senator BENTSEN. Mr. Spence, I appreciate your testimony very much. Our problem is going to be to try to get the administration to move on this. We sincerely solicit their opinions, but we are going to be pushing as hard as we can to get this implemented, because there are a lot of small plans that are just going by the boards, and it is difficult to get them reinstated.

I was not aware of that number of yours—you say 96 percent of the pension plans have 100 or less employees. They are the ones most directly and profoundly affected by ERISA.

Mr. SPENCER. Yes; in addition, there are still a lot of small plans that are in the midst of the compliance process. The IRS has indicated that they are concerned about the number of plans that have not yet been submitted for compliance with ERISA.

I still think something must be done rapidly so as to stop small employers from terminating plans at this point in time.

Senator BENTSEN. Thank you very much, Mr. Spencer.

That will conclude the hearings for this morning. We will reconvene at 10 o'clock tomorrow morning.

[Thereupon, at 11:20 a.m., the hearings in the above-entitled matter was recessed, to reconvene Wednesday, May 25, 1977.]

PENSION SIMPLIFICATION AND INVESTMENT RULES

WEDNESDAY, MAY 25, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
OF THE COMMITTEE ON FINANCE,
AND THE SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The joint hearings convened, pursuant to recess, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen presiding.

Present: Senators Bentsen and Curtis.

Senator CURTIS [presiding]. The committee will come to order. It is a pleasure to chair these hearings this morning on a topic that is vital to the continued growth of private retirement plans. S. 901, the Pension Simplification Act, is important to American business large and small.

One of the key factors of the bill is the elimination of dual jurisdiction of the administration of private retirement. This dual jurisdiction is a result of Congress acting in haste on complex legislation in order to meet an artificially imposed deadline.

I am pleased to note that the administration witnesses and others who have appeared before the subcommittee have testified in favor of allocating jurisdiction between the Internal Revenue Service and the Department of Labor. As one witness stated yesterday, dual jurisdiction has begat dual confusion, dual reporting, dual frustration and multitudinous filing dates.

I am hopeful that these hearings today will lead to the correction of these problems.

The first witness, from the American Bankers Association, is Charles Moran.

If you will come forward, please, and identify who accompanies you.

STATEMENT OF CHARLES A. MORAN, MEMBER, EMPLOYEES TRUST COMMITTEE OF AMERICAN BANKERS ASSOCIATION TRUST DIVISION AND VICE PRESIDENT, MANUFACTURERS HANOVER TRUST CO.; ACCOMPANIED BY ROBERT L. BEVAN, ASSOCIATE FEDERAL LEGISLATIVE COUNSEL, AMERICAN BANKERS ASSOCIATION

Mr. MORAN. Mr. Chairman, my name is Charles A. Moran. I am a member of the Employees Trusts Committee of the American Bankers Association's Trust Division and vice president of Manufacturers

Hanover Trust Co. I am accompanied by Robert L. Bevan, associate Federal legislative counsel of the American Bankers Association.

Some 4,000 banks serve as trustees and investment managers to employee benefit plans. Consequently, the association is vitally interested in your efforts to address the unnecessarily complex and burdensome administrative framework of ERISA and to legislate investment standards.

First, with respect to S. 901. The everyday business of bank trustees and investment managers and the interests of our trust beneficiaries is significantly affected in an adverse manner by some of the regulatory provisions of ERISA. The act has enmeshed us all in a web of conflicting, duplicative and unnecessary administrative procedures established by the agencies with jurisdiction over employee benefit plans.

Our institutions probably possess the ability to absorb, at substantial additional cost, the burdens of regulatory excess currently found in ERISA.

However, we are concerned that the disincentives created by these provisions may prove to be so great that the continued growth of benefit plan coverage may be jeopardized. And further, that employers who already have plans will be deterred from increasing benefits. While it is too early to draw firm conclusions from the plan termination and new plan formation data we do find it disturbing.

Just as Congress responded to isolated instances of abuse and misconduct in enacting ERISA we urge it to act once again and change those provisions which, today, threaten plan growth.

Provisions of the act which create the major problems we are currently experiencing are first, a litany of prohibited transactions; second, a broad definition of "party in interest"; and third, shared responsibility by the Department of Labor and the Internal Revenue Service.

We find ourselves hard-pressed to separate these provisions in attempting to find the principal cause of the current situation.

It is the interplay of the "overkill" provisions of section 406 and the jurisdiction issue which is the culprit.

Section 406(a) of the statute, as this subcommittee well knows, prohibits a number of itemized transactions between a plan and a party in interest.

The impact of these prohibited transaction provisions can only be fully appreciated in the light of the limitless definition of party in interest.

The ABA has spent a great deal of time considering whether the party in interest definition can be reduced to minimize its adverse effects without destroying the purpose of the prohibited transaction rule.

We found it quite impossible to achieve a satisfactory reduction in the persons covered except there was an element of agreement that the number could be reduced by elimination of "servicers" and employees of the company.

So it was also with our review of prohibited transactions. Each type of transaction was inserted in ERISA to protect participants against possible conflicts of interest. We have been unable to identify any specific transaction for elimination.

As a consequence, we must turn to the complicating factor of dual jurisdiction. As we see it, each of the agencies has its own traditional sphere of operation and has its own directive from Congress in the enforcement of its responsibilities under ERISA.

Thus, the dual jurisdiction mandated by the statute is inherently unworkable.

At this point, it might be appropriate to emphasize the fact that each provision we have mentioned in the labor law title of ERISA has a parallel provision in the responsibilities given to IRS. Thus, when you read the word "Secretary" in section 406 of ERISA, it means that IRS must also participate in all the proceedings and concur in the final decisions.

During the legislative progress of ERISA we raised the problems we anticipated in the application of its prohibited transaction provisions. The automatic answer was that an exemption procedure would be included which would alleviate the severity of the rules.

The exemption procedure which was established to eliminate hardship, however, has created a monumental logjam which prevents the orderly operation of the law.

After 2 years, Mr. Chairman, what has been the record? A very small number of exemptions have been granted. Most of the applications granted exempted individual transactions and have no universal application. In view of the time expended on these applications it is manifest that something must be done. This record persists in spite of dedicated, intelligent, hardworking people in both the Labor Department and the IRS working with goodwill to interpret the law.

We have recited the ABA's experience with the exemption procedure in our full statement submitted to the committee. I respectfully request that our full written statement be made a part of the record for this hearing.

Senator CURTIS. So ordered.

Mr. MORAN. These applications may provide some insight into the burdens of coping with ERISA.

There is agreement in much of the pension community that the concept of dual administration by the agencies must be reversed. Joint responsibility creates a need for continuing dialog which, in practice, has resulted in unintended delays.

Therefore we urge that the fiduciary responsibility provisions of ERISA including prohibited transactions be made the responsibility of one agency. The association believes the Labor Department is a logical location in which to place this responsibility, so to the extent S. 901 accomplishes this goal, it has our support.

The ABA, however, does not believe it is necessary to substitute civil penalties assessed by the Secretary of Labor for the repealed excise tax in the case of violations of prohibited transactions. The current enforcement authority of the Secretary under ERISA section 502 is completely adequate to protect participants and beneficiaries.

Banks serving as trustees have experienced consistent difficulty with the implementation of the reporting and disclosure provisions of ERISA. The provisions of section 4 of S. 901 amending section 103 may be helpful, in that it should result in the elimination of some unnecessary disclosures. However, since much of our problem with current law has resulted from delays by the Labor Department and IRS in publishing the forms and issuing the regulations we are concerned over the language of section 6 of S. 901 which again directs the Labor Department and IRS to act jointly.

The association believes the contents and filing date of the annual report should be completely in the jurisdiction of one agency which would be directed to consult with the other but the one agency's decision should be binding. Again, the Labor Department is a logical choice for determining the content of the annual report and the filing date.

If these steps are taken by Congress it would significantly ease many of the problems caused by ERISA, however, not all the major problems we have encountered. While they are not the subject of this hearing, the association has discussed a number of other needed changes in ERISA in our full statement and we urge early consideration of these issues.

Legislative changes in all these areas would, we believe, make the act more workable and would serve the best interest of the participants and beneficiaries of plans. It also might encourage additional employers to establish plans for their workers.

Mr. Chairman, turning to S. 285, the ABA believes it would unnecessarily interfere with the free marketplace and allocate capital through arbitrary investment restrictions. Its enactment could well have a diametrically opposite effect in some ways from the one intended.

Even though the bill only imposes the 5-percent limitation on those banks managing over $1 billion in pension assets, trusts departments of all sizes have expressed their opposition.

Five major reasons have been expressed for imposing the 5 percent limitation on large pension managers. The first of these is that excessive concentration of pension investments in a few select stocks raises disturbing questions about the safety of the enormous amounts of pension money.

The Employee Retirement Income Security Act of 1974 specifically imposes on every pension manager the duty to diversify the investments of a pension plan so as to minimize the risk of large losses. Thus, there is no need for a flat percentage test to protect pension plan beneficiaries from an excessive concentration of investments.

The second expressed reason for the 5 percent limitation is to help prevent a small number of large institutions from achieving too much control over our entire economy.

To date, even though there have been a number of studies, such as the SEC Institutional Investor Study and the 20th Century Fund Trust Department Study, little, if any evidence, has been found that bank trust departments exercise, or attempt to exercise, control over portfolio companies. As indicated above, a bank trustee under ERISA must discharge its duties solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing plan benefits. Consequently, bank trustees are prohibited by law from using pension assets to control American business.

While any listing of trust department holdings will undoubtedly include some company holdings of significant size, they are the exception rather than the rule and normally there is some particular reason why any holding is significant, that is, a company that had its beginning locally and its stock was extensively held by members of the community whose estates and trusts are managed by the bank. Also, such listings of trust department holdings are seldom refined to disclose those stocks over which the bank has complete investment or voting discretion and those over which discretion is shared or those over which the bank has neither. Thus, these figures provide very soft information even as to the potential ability of a bank to exercise control over a company.

Reference has been made that many banks voluntarily limit their holdings to 5 percent. This is true. However, because it is voluntary, a bank has the needed flexibility to exceed 5 percent, either by purchase of securities or accepting a new account that contains such securities, when it is in the interest of its customers.

The third expressed reason for the limitation is to help provide greater liquidity in the stock market. Actually the limitation, if it would have any affect on liquidity, would be to reduce it rather than make it greater. Market decisions include not only decisions include not only decisions to buy or sell, but decisions not to buy or sell.

Statistics which provide the percentage of transactions participated in by any one investor in no way indicate the total number of investment decisions that were made relative to those transactions. It is all such decisions which establish the price, not just the actual transactions that are consummated. Transactions only reflect the consequences of the decisions.

The question that really should concern us regarding liquidity is what would have happened if sellers, whether they be individuals or institutions, had come to the market to sell securities and any institution that might purchase a large percentage of the amount traded of a security had not been there willing to buy at the offered price.

The presence of a significant buyer in the market means liquidity to other securities holders. Banks have learned the other side of the coin, that is, how to deal with liquidity when they are a significant seller. The record shows that trust departments have moved substantial holdings without any significant impact on price.

A list of the securities in which a bank trust department has a significant share of the market as net seller or buyer during any one year would again be small relative to the number of securities held by the department or the number of securities available for purchase. So again, it is easy to misunderstand the significance of the statistics which have been published because they are seldom presented in the context of the whole. Rather for shock value, a few specific situations are enumerated without any background information.

Reference has been made to self-fulfilling prophesies, but if any lesson has been learned in the market in the last few years it is that any such plans or hopes would be illusory.

The fourth expressed reason for the limitation is that it would encourage the spread of pension assets among a larger number of managers. Pension investment managers are selected because of their ability to invest the entire pension portfolio completely. They are seldom hired to invest in any one stock. So the fact a manager was up to the limitation in some stock would probably have little or no bearing on its selection.

This demonstrates, however, one of the major objections to the 5 percent limitation. It establishes an arbitrary barrier which distorts the decisionmaking process of pension investment managers, and possibly those who select them. Decision makers would no longer be able to limit their thinking to investment considerations and plan needs. Instead, they would also have to consider the legal limitation.

This may be the ultimate detriment of the participants and beneficiaries of pension plans. We are already experiencing the adverse impact on investment management of the flat restriction of the prohibited transaction provisions of ERISA.

The fifth expressed reason for the limitation is that it would encourage greater institutional interest in the many other well-managed companies that now have seriously limited access to our Nation's capital markets. There is no reason to believe that the limitation would have this effect.

On a number of occasions witnesses from bank trust departments have testified before this committee that there is a continuing search for well managed small- and medium-sized companies. Less than 4 years ago this association testified before the Senate Financial Markets Subcommittee that a survey had disclosed that among trust departments with more than $750 million in assets the average number of companies whose equities were held was 2.543.

Traditionally, trust department investments have not been viewed in the aggregate since the investment decisions are not made in the aggregate. The many trusts and many beneficiaries involved provides diversification in and of itself. The imposition of an aggregate limitation will undoubtedly deny some beneficiaries the advantages of certain investments enjoyed by other beneficiaries.

Over the years, the prudent man rule has provided flexibility to trust investment activity where before its adoption there had been strict limitation—legal lists. Because of its flexibility, it has withstood the passage of some 150 years. Should the Congress now impose a strict limitation on investment activity?

The association also opposes the 2 percent leeway provision which would allow a pension manager to invest 2 percent of a pension trust in companies with capital less than $25 million without concern for the prudent man rule. This further erosion of the prudent man rule is not necessary because of the flexibility of the rule itself.

We recognize that many investment managers have misconstrued the prudent man rule of ERISA and have become more conservative. The Association's Employees Trusts Committee has worked since September 1974, to convince pension managers that ERISA actually provides greater flexibility to the pension trustee than is enjoyed by the personal trust trustee. To a substantial degree we believe we have been successful. However, it might be very helpful if Congress were able in some way to restate its intent. The language of the rule as contained in ERISA should not be changed, however, since it was developed very carefully and really states well what the law should be. Any attempt to amend it by adding more specific language can only in the long run reduce its effectiveness.

Our concern over the 2-percent provision runs not only to the potential abuse which could be made of it but also to the standard which might be inferred from it. Would any investment over 2 percent in a company with less than $25 million capital automatically be deemed, presumed, or even suggested to be imprudent? Would any investment in such a company be tainted for personal trust investments? Should this occur, the proposal would prove self-defeating.

The ABA supported the adoption of a Federal prudent man rule for many years before it was enacted. Time and again, we came before Congress to urge the passage of such a law. We strongly believe the interests of pension participants and beneficiaries as well as our Nation's capital market needs will best be served by the flexibility of this rule without any arbitrary limitations or exclusions. If specific problems exist or arise, they should be dealt with directly rather than indirectly through investment limitations or license.

Mr. Chairman, the association would be happy to work with you and your staff in developing solutions to any problems which may exist but we must oppose S. 285.

Senator CURTIS. I want to ask you a few questions.

For several decades we had a great increase in the private pensions in our country, is that not correct?

Mr. MORAN. Yes, sir.

Senator CURTIS. What happened upon the enactment of ERISA to the growth of pension plans in the United States?

Mr. MORAN. We certainly are not the only ones who have tried to come up with an answer to that question. I do not think we have a complete answer to that question.

Senator CURTIS. What is your partial answer?

Mr. MORAN. There are a number of things that seem to have interacted here. One of them has clearly been the state of the economy for a period of time since ERISA occurred. Another has been a great deal of the——

Senator CURTIS. You have been listening to too many political speeches. The fact is that ERISA has put a stop to pension formation, is that not correct? The complications and the requirements has caused many small and medium-sized businesses to have to back away from establishing pension plans. Do you believe that?

Mr. MORAN. I would agree that that is a major factor.

Senator CURTIS. Yes.

I had some experience in this. I happen to be the author of the Individual Retirement Act. It did not come into the dual committee jurisdiction, and therefore was unspotted.

A symposium was held in my State, sponsored by the College of Business Administration of the University of Nebraska; the accountants, the lawyers, insurance companies, bankers, and others copped out. We had a full day. We invited businessmen, corporate and unincorporated, all kinds, for a discussion.

There was intense interest in the individual retirement act because it opens up an avenue for half of our population for retirement. All day long there was not a single busnessman or company that came in and said, how do you start a pension plan. All day long, they asked the question, how do you end one, how do you terminate one.

The dual reporting, the dual complications, how do you resolve that?

Many well-meaning Congressmen and Senators thought that they were enacting rules to serve the American people, but by complications of ERISA, they denied pensions for a period of time to a great many men and women in the country.

Is it not true that the rate of termination of pension plans has been greatly accelerated since the passage of ERISA?

Mr. MORAN. The statistics certainly show that.

Senator CURTIS. Yes. ERISA will stand as a monument of the injury that can be done to the rank and file of people by overregulation.

Here you had a movement in this country which was bringing pensions to more millions every decade and is growing. Then Washington did too much messing.

Is it not true that the basic private pension idea rests primarily on our tax laws? Is that not right?

Mr. MORAN. Historically, yes.

Senator CURTIS. Historically, I think it does today. Could you run a pension plan if the contributions to the plan were after taxes instead of before?

Mr. MORAN. No.

Senator CURTIS. Could you run a pension plan that paid anything that amounted to anything if the fund itself were taxed?

Mr. MORAN. No.

Senator CURTIS. That is why the Internal Revenue Service will always have to be in the act. It is why they, through long years of experience and trial and error, developed a plan of policing, if you please, private pensions in such a way that more and more companies are called on to provide pension plans for their employees. Instead of correcting the things that needed to be corrected, they did nothing.

We appreciate your appearance here, and thank you very much.

Mr. MORAN. Thank you.

Senator BENTSEN. Mr. Moran, I was not here for your testimony. Could I ask you to come back? We have differing views on this piece of legislation.

One of the problems we have is the way that the prudent man rule is now being interpreted 64 percent of the pension trustees surveyed by the International Foundation for Employee Benefit Plans in 1976 stated that as a result of the 1974 Pension Reform Act, they were less willing to invest in anything other than a large company.

One of the purposes of my proposal leeway clause is to correct this unintended side effect of ERISA. What I have proposed is something that has existed for a long time for insurance companies and I have frankly heard little criticism of it with respect to insurance companies.

Would you care to comment on that?

Mr. MORAN. First, I am not familiar with the International Foundation study, so I do not know who they studied. Talking just about my own bank—and I think it is similar in the industry, we have a fund that invests specifically in small capitalization companies. We have an additional fund that invests in medium capitalization companies. We are actively looking for companies to include in those funds. Those funds have broad participation from the accounts that we manage. Both funds are set up separately from the basic investment of pension moneys and are available to all of the pension funds that we manage. We have, for some time, been active in that area.

I think that the problem with the 2-percent leeway is that we are concerned about either positive or negative controls or regulations on the prudent man rule. We think that the prudent man rule has, as it stands, no limitation on the flexibility to invest in small companies in the prudent man rule.

Senator BENTSON. In actuality, there is a restriction now. The reaction that we are getting time and time again is they are saying, if I go into that little-known small company and if it fails, then they are going to second-guess me and they are going to seriously question my judgment on it. But if I buy very large company stock, be it General Motors or IBM, American Tel & Tel or Penn Central, and that company goes down the tube, then they say well, that is life. We made a mistake. But it is not something that you are seriously questioned on.

Mr. MORAN. The number of people that are being sued for holding Penn Central are being questioned. I would anticipate that would happen with other large companies if the same thing happened to them. The point is it is an educational problem more than a problem with the law. I think that it is a matter of becoming accustomed to and having a little experience operating under this prudent man rule. It really is not corrective legislation we need, but further education as to what this means and experience.

Senator BENTSEN. Could there not be some adverse court judgment along the way in interpreting it? That is the problem. I get all of these lawyers up here who argue that we ought to be looking at all of the securities, the total portfolio, to determine whether we are being prudent in one investment. Others disagree in that interpretation.

Whenever you get that kind of a difference of opinion, then the portfolio manager says the safe thing for me to do is just to take the big ones. That is what concerns me very much. I would be delighted to look at it as a total portfolio if all the judges were to look at it that way.

Mr. MORAN. From my personal viewpoint I think the total portfolio is appropriate to look at. I do not see any reason why people are uptight about that as being the only test. As long as you are looking at the investments at the time they are made, rather than at the benefit of hindsight—I think there is no problem in investing under the prudent man rule, if you are looking at small companies or large companies.

Senator BENTSON. Human nature. When I cast a vote on May 25, the electorate looks at it 6 years later when I run for re-election. So does my opponent, and he views it in conditions as they are then, and some folks forget what the conditions were on May 25, 1977.

The same thing happens on investments. They get so smart later with the benefit of hindsight. That concerns me.

Mr. MORAN. One of the things that we have done about that is that we have shored up our recordkeeping on decisionmaking as we go along so that we have a record at some future date to show to somebody.

I would hope—I realize it is just a hope—that a judge is more able to put aside hindsight than the electorate often is.

Senator BENTSEN. If I were sitting there as a portfolio manager I would make my problems easier by investing in a great big company and taking it away from the small one. Tell me this. Of all these years that the insurance companies have had this investment leeway clause, have you heard of any serious difficulties with the utilization of that?

Mr. MORAN. Personally I am not familiar with any.

Senator BENTSEN. I personally am. I used to be in that business for years. I have never found any problems with it.

Mr. BEVAN. I might add, normally in the case of the insurance company, this applies to the general fund of the insurance company which is really the insurance company's own assets. Bank trustees are specifically always dealing with somebody else's assets, managing somebody else's assets. That would make a distinction.

Senator BENTSEN. The insurance company has the policyholders' investments.

Mr. BEVAN. I might add to the statement, as we pointed out in our full statement, the association and our committee have recognized, this problem of a misconstruction of the prudent man rule under ERISA since September 1974. It has constantly pursued the educational side of it, trying to say a trustee of an employee benefit plan has more flexibility under the Federal prudent man rule of ERISA than a personal trustee does. It was drafted for that purpose.

We have pursued that point in our efforts to educate people to avoid this kind of a more conservative attitude.

Senator BENTSEN. What is your concern? Are you afraid that I am going to tell you that you have to put 10 percent into homebuilding and 10 percent into manufacturing, or something like that? Is that your concern?

I am totally opposed to that kind of approach. I am not trying to do that.

Mr. MORAN. Obviously, that is a concern. I think probably all of this falls under the same kind of umbrella. We are very comfortable with the prudent man rule as it is stated, and any limitations on it, I think, we would find troublesome.

Senator BENTSEN. I cited to you the survey that 64 percent of these pension trustees say they then had to go into blue chip stocks.

Mr. MORAN. I am not familiar with that. I do not know what percentage of them are bank trustees, individual trustees, or what the background of those people is. Unfortunately, I cannot comment on that.

Senator BENTSEN. Do you think that there is that much difference between a bank trustee or whatever kind of trustee we may have?

Mr. MORAN. If you look at all trustees, large trustees, small trustees, individual trustees, there is a difference in how successful the educational efforts have been on exploring the breadth of the prudent man rule.

Senator BENTSEN. Are you saying that bank trustees are better educated?

Mr. MORAN. I think the large ones have listened to the education.

Senator BENTSEN. Let us talk about the 5-percent limitation. You prefer no limitation, I assume.

Mr. MORAN. Yes, sir.

Senator BENTSEN. Why do you think it is so onerous that my piece of legislation would limit you when you have over 1,500 companies listed on the New York Stock Exchange, to say that you ought to reasonably distribute your stock. Why is that so tough?

Mr. MORAN. I am not sure that it is so onerous. I think it is the possible results rather than the presently viewed results that caused the problem. We stated in our prepared statment that it has been suggested that most institutions have a voluntary limit of 5 percent and I think this is true, for the most part.

I think the concern is if you formalize that barrier, then you are introducing an additional restriction in the decisionmaking process which may cause problems as opposed to causing problems that are readily identified at this point in time.

For my institution, at this moment, it is not a real problem at 5 percent. But certainly it is a potential problem and it introduces an artificial barrier that I am not sure we can find justification for introducing.

Senator BENTSEN. I think you have justification by those few who have attempted to exceed it in instances, and I have cited a number of instances. You can get into a situation where you get a portfolio manager who has a self-fulfilling prophecy by continuing to buy and be a very major part of the trading volume in that stock in that year. I have cited instance after instance of that type of thing.

Mr. MORAN. You have currently in the law that everybody has the responsibility to diversify as to minimize the risk of large losses. I think that is a very powerful restraint, in fact.

Also, as we mentioned in our statement, a lot of the statistics are difficult to evaluate because they are taken out of the context of the total number of decisions made or the total number of securities held by a particular institution.

Senator BENTSEN. We showed one bank that held 12 percent of Schlumberger's stock in 1973 and sold one out of eight shares of Schlumberger traded in 1974–75. One book had 11 percent of the outstanding shares of Philip Morris and that bank sold 1 out of 10 shares and also brought 1 out of 20 of Philip Morris shares traded in 1974. In 1975, it sold one out of every eight Philip Morris shares traded.

Mr. MORAN. That sounds like they are coming back down to the 5 percent.

Senator BENTSEN. They had better. Some of them took a real bath with some of their concentration, and I mentioned this when I started these hearings before.

It shows that one of them bought 38½ percent of all the shares of Kaiser Aluminum and Chemical in 1975, 30.8 percent of International Nickel volume, net purchases in that year. In 1973, 1974, and 1975, there were 128 instances where one of the bank's net purchases or net sales on the New York Stock Exchange stocks exceeded 5 percent of total volume in that stock. In 16 of those instances, the bank accounted for more than 20 percent of the buying and selling.

Obviously, they do not apply your rules. If everybody put the self-imposed limitations on, fine. It is the aberration that we are talking about and trying to protect the participants, plan participants in this country. The pension plans under ERISA are going to escalate substantially in the amount of money that is put in.

I am deeply concerned.

Gentlemen, do you have anything further to add?

Mr. BEVAN. The only think I would add to the last statistic that you presented, with that background, there may be some explanation. I would hope that whoever was the investment manager in those cases might be in a position to explain the specifics of those statistics, standing alone out there, they are impressive. There may be some background reason for them; when you put them in full context of all the facts they may not come across the same as they do as bare statistics.

Senator BENTSEN. I have not heard the statistics questioned by that institution.

Mr. BEVEN. I am not challenging the fact that those are the statistics. I am saying that there may be some background information on those particular numbers that may have some significance.

Senator BENTSEN. All right. Thank you very much.

Mr. MORAN. Thank you.

[The prepared statement of Mr. Morgan follows:]

STATEMENT OF CHARLES A. MORAN ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the committee, my name is Charles A. Moran. I am a member of Employees Trusts Committee of the American Bankers Association's Trust Division and vice president of Manufacturers Hanover Trust Co. I am accompanied by Robert L. Bevan, associate Federal legislative counsel of the American Bankers Association. The American Bankers Association has 13,252 bank members which constitutes about 92 percent of the banks in the country. Some 4,000 of these banks have fiduciary powers and most of these serve as trustees and investment managers to employee benefit plans. Consequently, the association is vitally interested in your efforts to address the unnecessarily complex and burdensome administrative framework of ERISA and to legislate investment standards.

S. 901

The everyday business of bank trustee and investment managers and the interests of our trust beneficiaries is significantly affected in an adverse manner by some of the regulatory provisions of ERISA. The Act has enmeshed us all in a web of conflicting, duplicative and unnecessary administrative procedures established by the agencies with jurisdiction over employee benefit plans. I will not suggest to you that our problems under the Statute are beyond our capabilities to cope. Candidly speaking, our institutions probably possess the ability to absorb, at substantial additional cost, the burdens of regulatory excess currently found in ERISA. However, many of our customers are not so fortunate and find themselves hard pressed to meet the added burdens required to maintain a plan. We are concerned that the disincentives created by these provisions may prove to be so great that the continued growth of benefit plan coverage may be jeopardized. And further, that employers who already have plans will be deterred from increasing benefits. While it is too early to draw firm conclusions from the plan termination and new plan formation data we do find it disturbing.

Our own experience suggests that plan sponsors are in fact substantially less inclined to undertake the responsibility of adopting a plan than they were before passage of ERISA. To the extent that this reluctance stems from provisions in the Act which provide no direct benefit to participants, they should be changed. Just as Congress responded to isolated instances of abuse and misconduct in enacting ERISA we urge it to act once again and change those provisions which, today, threaten plan growth.

In our view several provisions of the Act create the major problems we are currently experiencing first, a litany of prohibited transactions; second, a broad definition of "party in interest;" and third, shared responsibility by the Department of Labor and the Internal Revenue Service.

We find ourselves hard pressed to separate these provisions in attempting to find the principal cause of the current situation. It is our view that it is the interrelationship and the interplay of these three provisions which results in considerable confusion, delay and uncertainty. You have selected one of these areas as one subject of your hearing today, dual jurisdiction. It is our intention to support your efforts to alleviate the problems which have arisen as a result of this curious arrangement. Quite frankly, Mr. Chairman, our frustration with the status quo is such that we feel constrained to assist any initiative which has as its purpose the elimination of any of those elements of the Act which operate to create the current environment.

As we have indicated, it is the interplay of the "overkill" provisions of section 406 and the jurisdiction issue which is the culprit.

Section 406(a) of the Statute, as this subcommittee well knows, prohibits a number of itemized transactions between a plan and a party in interest, such as sales or exchanges of property, lending of money, furnishing of goods or services and the transfer to or use by a party in interest of any assets of the plan.

The impact of these prohibited transaction provisions can only be fully appreciated in the light of the limitless definition of party in interest [section 3(14) of the Statute]. Who are parties in interest? Not only fiduciaries, administrators, officers, trustees, custodians, counsel or employees of the plan and employees of the company, but also any relative of such person which includes a spouse, ancestor, lineal descendant or spouse of a lineal descendant. The list goes on to include a host of others, including "servicers" as well as substantial employers and owners. On the tax side, a definition of similar scope describes these individuals as "disqualified persons."

The ABA has spent a great deal of time considering whether the party in interest definition can be reduced to minimize its adverse effects without destroying the purpose of the prohibited transaction rule.

We found it quite impossible to achieve a satisfactory reduction in the persons covered except there was an element of agreement that the number could be reduced by elimination of "servicers" and employees of the company.

So it was also, with our review of prohibited transactions. Each type of transaction was inserted in ERISA to protect participants against possible conflicts of interest. We have been unable to identify any specific transaction for elimination.

As a consequence, we must turn to the complicating factor of dual jurisdiction. As we see it, each of the agencies has its own traditional sphere of operation and has its own directive from Congress in the enforcement of its responsibilities under ERISA. The Internal Revenue Service has as its primary responsibility collection of taxes and the Department of Labor has a primary duty to protect the interests of working people. Thus, the dual jurisdiction mandated by the Statute is inherently unworkable and has been recognized by most people who were involved in the original legislation as a necessary compromise, not a workable one.

At this point it might be appropriate to reemphasize the fact that each provision we have mentioned in the labor law title of ERISA has a parallel provision in the responsibilities given to the IRS. Thus, when you read the word "Secretary" in section 406 of ERISA, it means that IRS must also participate in all the proceedings and concur in the final decisions.

During the legislative progress of ERISA we raised the problems we anticipated in the application of its prohibited transaction provisions. The automatic answer was that an exemption procedure would be included which would alleviate the severity of the rules. We were skeptical and unfortunately, the procedure has not proven an effective administrative remedy.

The exemption procedure which was established to eliminate hardship as long as the exemption was consonant with the protection of participants, has created a monumental logjam which prevents the orderly operation of the law.

After 2 years Mr. Chairman what has been the record? A very small number of exemptions have been granted. Most of the applications granted exempted individual transactions and have no universal application. In view of the time expended on these applications it is manifest that something must be done. This record persists in spite of dedicated, intelligent, hard-working people in both the Labor Department and the IRS working with goodwill to interpret the law.

To be parochial for a minute, the ABA has filed three applications for exemption. These applications may provide some insight into the burdens of coping with ERISA.

The first application filed in December 1976 requested issuance of a class exemption from prohibited transactions with respect to certain acquisitions of certificates of deposit and other short-term obligations of banking organizations. The purpose of the application is to eliminate possible violations of the prohibited transaction rules of ERISA where more than one bank has been named as trustee or investment manager of a single employee benefit plan. In these situations, each bank is responsible for the investment and administration of its own portion. The possible violation arises when one bank invests short-term money in the obligations of the other.

In January of this year we filed the second application for exemption. This application requested a class exemption from prohibited transactions of purchases of securities in the public marketplace by employee benefit plans when the proceeds of sale are used by the issuer of the securities directly or indirectly to retire or reduce indebtedness to banks which are parties in interest or disqualified persons with respect to the employee benefit plans.

The third application was filed early this month. It requested a class exemption making it clear that collective trust fund assets are not assets of the plans holding participations or interests in such collective funds.

There is agreement in much of the pension community that the concept of dual administration by the agencies must be reversed. It was a self-destructive concept *ab initio*. Granting goodwill on the part of each participating agency, joint responsibility creates a need for continuing dialogue which in practice has resulted in unintended delays. But the basic problem is more substantial; each agency interprets the Statute from its own tradition and with a consciousness of its own role in the statutory scheme.

Therefore, we urge that the fiduciary responsibility provisions of ERISA including prohibited transactions be made the responsibility of one agency. The Association believes the Labor Department is a logical location in which to place this responsibility, so to the extent S. 901 accomplishes this goal, it has our support.

The ABA, however, does not believe it is necessary to substitute civil penalties assessed by the Secretary of Labor for the repealed excise tax in the case of violations of prohibited transactions. The current enforcement authority of the Secretary under ERISA section 502 is completely adequate to protect participants and beneficiaries.

Banks serving as trustees have experienced consistent difficulty with the implementation of the reporting and disclosure provisions of ERISA. The provisions of section 4 of S. 901 amending section 103 may be helpful, in that it should result in the elimination of some unnecessary disclosures. However, since much of our problem with current law has resulted from delays by the Labor Department and the IRS in publishing the forms and issuing the regulations we are concerned over the language of section 6 of S. 901 which again directs the Labor Department and IRS to act jointly. The sixty day deadline may result in a quick form but would the form be amendable to correct mistakes in the initial decisions of the agencies or to deal with changing times? The association believes the contents and filing date of the annual report should be completely in the jurisdiction of one agency which would be directed to consult with the other but the one agency's decision should be binding and the other agency should be prohibited from seeking such data. Again, the Labor Department is a logical choice for determining the content of the annual report and the filing date.

If these steps are taken by Congress it would significantly ease many of the problems caused by ERISA, however, not all the major problems we have encountered.

While they are not the subject of this hearing, the association urges the subcommittee also to take early action on these other needed changes.

We urge the subcommittee, first, to substitute the duty of undivided loyalty and the sole benefit test of section 404 for the strict party in interest prohibitions of section 406(a). As pointed out earlier, we are unable to suggest a realistic cut back on either the scope of the party in interest definition or the type of transactons that give rise to conflict problems. Therefore, the only sound approach seems to be the adoption of a rule that bases prohibited transactions on the criteria of adequate consideration. The disclosure required by the Statute of prohibited transactions by plans would help militate against infractions.

Another problem which needs alteration is the definition of fiduciary. Fiduciary is defined in such broad terms under the Statute that the definition could even be read to include each individual employee of a corporate trustee. We believe this does not recognize the manner in which corporations operate.

Every corporation must act through individuals. The selection of the corporate trustee is made after careful analysis and review of its policies, reputation, experience, performance and indeed after consideration of its financial stability. No review is made—or is possible—of the financial condition of the individuals who will operate the account.

In comments we filed with the Labor Department and the IRS dated March 13, 1975, we referred to this issue in these words: "In these cases, the sponsor of the plan selects an entity to be its trustee or other fiduciary, not the individuals who are associated with and who act on behalf of the entity. Without such individuals, entities which serve as fiduciaries cannot act; however, such individuals do not act in their own right or on their own behalf, but solely on behalf of and in the name of the entities with which they are associated. The inseparability of directors, officers, and employees from a corporate trustee has been universally recognized, for example:

> 'Although a corporate trustee cannot properly delegate the administration of the trust, it can properly administer the trust through its proper officers. Restatement, Trusts, 2d. Sec. 171e.
>
> 'The artificial legal entity which is the corporation cannot act personally. It can proceed only through its officers and employees or other intermediaries. The use of officers and employees is not delegation but rather action of the trustee itself. Trusts and Trustees, Bogert, 2d Ed. 1960, Ch. 27. Sec. 555.' "

Even certain provisions of ERISA seem to recognize this inseparability. Section 405(d)(1), protects a trustee from liability for following the instructions of an investment manager. If the directors, officers, and employees acting on behalf of a corporate trustee were fiduciaries individually, they could arguably be liable for carrying out instructions of an investment manager even though their employer was relieved from liability for its actions. Such a result could not have been intended.

Therefore, we urge the adoption of a very simple addition to the statutory definition in Sec. 3(21), "If a corporation or an employee organization is a fiduciary with respect to a plan, under subparagraph (A), a director, officer, or employee of such corporation or employee organization when acting in such capacity, shall not be a fiduciary with respect to such plan."

Another problem is the somewhat ambiguous language introduced by section 405(b) of ERISA into the liability created for actions of "co-trustees". In sec. 405(b)(1)(A) a co-trustee is required "to use reasonable care to prevent a co-trustee from committing a breach."

Traditionally under the law co-trustees exist only in those instances in which the instrument creating the trust appoints more than one trustee to act in concert over the same assets. The ERISA Conference Report seems to recognize this when it says:

"Allocation of duties of co-trustees.—Under the conference substitute, if the plan assets are held by co-trustees, then each trustee has the duty to manage and control those assets. For example, shares of stock held in trust by several trustees generally should be registered in the name of all the trustees, or in the name of the trust. In addition, each trustee is to use reasonable care to prevent his co-trustees from committing a breach of fiduciary duty."

This situation is quite distinct, however, from the situation where each of several trustees is given responsibilities, obligations and duties over a different portifolio of assets. To look upon these trustees as co-trustees is quite contrary to trust law.

The Statute and the Conference Report recognize in several places that pension assets of large plans may have multiple trustees as opposed to co-trustees. Therefore, we urge that section 405 be amended to assign liability more accurately. Co-trustee liability should be limited to those situations in which trustees are acting in concert. We have drafted some legislative language to achieve this result, which we would be glad to provide the subcommittee.

Mr. Chairman, this list does not exhaust the problems which banks have encountered and most of these items are not even the subject of this hearing but the adoption of legislative changes in these areas would, we believe, make the Act more workable and would serve the best interest of the participants and beneficiaries of plans. It also might encourage additional employers to establish plans for their workers.

S. 285

Mr. Chairman, S. 285, we believe, would unnecessarily interfere with the free marketplace and allocate capital through arbitrary investment restrictions and its enactment could well have a diametrically opposite effect in some ways from the one intended.

Even though the bill only imposes the 5 percent limitation on those banks managing over $1 billion in pension assets, trust departments of all sizes have expressed their opposition.

Five major reasons have been expressed for imposing the 5 percent limitation on large pension managers. The first of these is that excessive concentration of pension investments in a few select stocks raises disturbing questions about the safety of the enormous amounts of pension money. The Employee Retirement Income Security Act of 1974 specifically imposes on every pension manager the duty to diversity the investments of a pension plan so as to minimize the risk of large losses. Even in exempting profit-sharing and other eligible individual account plans from this diversification requirement in the case of employer securities ERISA subjects the holding of employer securities to the prudent man rule and the exclusive benefit test. Thus there is no need for a flat percentage test to protect pension plan beneficiaries from an excessive concentration of investments.

If there is concern, however, that individual plan diversification somehow does not provide adequate protection thus requiring a limit on aggregate holdings it should be noted that the banks subjected to the 5 percent limitation, those with over $1 billion in pension assets, are the banks that are the most highly capitalized and most able to cover any losses due to imprudence or failure to diversity as required by ERISA.

Managers who manage profit-sharing or employee stock ownership plans with assets over $1 billion are exempted in S. 285 from the definition of pension manager and thus from the five percent limitation. While the definition of pension manager is not all that clear, presumably the managers of smaller profit-sharing or ESOP plans would be subject to the limitation, as well as a manager of a billion dollar proft-sharing plan who also manages other pension assets. Or, does the management of a billion dollar profit-sharing plan exempt the manager even though he manages other pension assets? Regardless, however, of the specific meaning of the profit-sharing exemption, why should smaller profit-sharing plans be subject to the limitation. Indeed, it is discriminatory to the participants and beneficiaries of all other plans to subject them through their pension manager to an arbitrary limitation on investment judgment.

The second expressed reason for the 5 percent limitation is to help prevent a small number of large institutions from achieving too much control over our entire economy. The 5 percent limitation, even if there were some danger of this occurring, would not prevent it. All it could achieve at most, would be to level out the stock holdings of large pension managers in individual companies.

To date, even though there have been a number of studies, such as the SEC Institutional Investor Study and the 20th Century Fund Trust Departmnt Study, little, if any evidence, has been found that bank trust departments exercise, or attempt to exercise, control over portfolio companies. As indicated above, a bank trustee under ERISA must discharge its duties solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing plan benefits. Consequently, bank trustees are prohibited by law from using pension assets to control American business.

While any listing of trust department holdings will undoubtedly include some company holdings of significant size, they are the exception rather than the rule and normally there is some particular reason why any holding is significant.

e.g., a company that had its beginning locally and its stock was extensively held by members of the community whose estates and trusts are managed by the bank. Also, such listings of trust department holdings are seldom refined to disclose those stocks over which the bank has complete investment or voting discretion and those over which discretion is shared or those over which the bank has neither. Thus, these figures provide very soft information even as to the potential ability of a bank to exercise control over a company.

Reference has been made that many banks voluntarily limit their holdings to five percent. This is true. However, because it is voluntary a bank has the needed flexibility to exceed 5 percent, either by purchase of securities or accepting a new account that contains such securities, when it is in the interest of its customers.

The third expressed reason for the limitation is to help provide greater liquidity in the stock market. Actually the limitation, if it would have any affect on liquidity, would be to reduce it rather than make it greater. Market decisions include not only decisions to buy or sell but decisions not to buy or sell. Thus, any statistic which provides the percentage of transactions participated in by any one investor in no way indicates the total number of investment decisions that were made relative to those transactions and it is all these decisions which establishes the price not just the actual transactions that are consummated. The transactions only reflect the consequences of all the decisions, those not to buy or sell as well as those to do so.

A single significant percentage figure on one investor's share of the market in a security during a year can be easily misconstrued unless one looks at the other side of the transactions. While a single institution may account for 30 percent of the net purchases of a security, on the sellers side there were offsetting individual investment decisions that the price was right so that amount of securities was sold. Undoubtedly, there were also other security holders who decided the price was not high enough and did not sell. The question that really should concern us regarding liquidity is what would have happened if these sellers, whether they were individuals or institutions, had come to the market to sell these securities and the institution that purchased such a large percentage of the amount traded of that security had not been there willing to buy at that price.

The presence of a significant buyer in the market means liquidity to other securities holders. Banks have learned the other side of the coin, that is, how to deal with liquidity when they are a significant seller. The record shows that trust departments have moved substantial holdings without any significant impact on price.

A listing of the securiites with respect to which a bank trust department had participated in a significant amount of the trades as net seller or buyer during any one year would again be small relative to the number of securities held by the department or the number of securities available for purchase. So again, it is easy to misunderstand the significance of the statistics which have been published because they are seldom presented in the context of the whole. Rather, for shock value, a few specific situations are enumerated without any background information.

Reference has been made to self-fulfilling prophesies, but if any lesson has been learned in the market in the last few years it is that any such plans or hopes are illusory.

The fourth expressed reason for the limitation is that it would encourage the spread of pension assets among a larger number of managers. Pension investment managers are selected because of their ability to invest the entire pension portfolio competently. They are seldom hired to invest in any one stock. So the fact a manager was up to the limitation in some stock would probably have little or no bearing on its selection. The administrator of a pension plan, after review of the capabilities of several investment managers is very unlikely to turn away from the one he decides on because one, two, or a few stock holdings of the manager are at the limitation. Should such an issue arise the problem might be resolved by the administrator directing the purchase of the forbidden security and the investment manager assuming discretion for the remainder of the pension trust assets.

This demonstrates, however, one of the major objections to the 5 percent limitation. It establishes an arbitrary barrier which distorts the decisionmaking process of pension investment managers, and opssibly those who select them.

Decision makers would no longer be able to limit their thinking to investment considerations and the plan needs. Instead, they would also have to consider the legal limitation. This may be to the ultimate detriment of the participants and beneficiaries of pension plans. We are already experiencing the adverse impact on investment management of the flat restriction of the prohibited transaction provisions of ERISA.

Another issue related to this fourth reason for the limitation is the impact on a plan that has certain holdings but wishes to select a new investment manager. Is it fair to the beneficiaries of the plan to deny them the services of the new manager who may be able to serve them better solely because the manager would be pushed over the five percent limitation if the plan were accepted?

The fifth expressed reason for the limitation is that it would encourage greater institutional interest in the many other well managed companies that now have seriously limited access to our Nation's capital markets. There is no reason to believe that the limitation would have this effect.

On a number of occasions witnesses from bank trust departments have testified before this committee that there is a continuing search for well managed small and medium-sized companies. Less than 4 years ago this association testified before the Senate Financial Markets Subcommittee that a survey had disclosed that among trust departments with more than $750 million in assets the average number of companies whose equities were held was 2,543. Among these trust departments 68 percent reported that their largest 25 holdings represented less than 50 percent of the equities held. Thus, it is clear that bank trust departments do invest in a broad number of companies. And, the number is not likely to be expanded by the proposed 5 percent limitation.

Traditionally, trust department investments have not been viewed in the aggregate since the investment decisions are not made in the aggregate. The many trusts and many beneficiaries involved provides diversification in and of itself. The imposition of an aggregate limitation will undoubtedly deny some beneficiaries the advantages of certain investments enjoyed by other beneficiaries.

Over the years, the prudent man rule has provided flexibility to trust investment activity where before its adoption there had been strict limitation (legal lists). Because of its flexibility, it has withstood the passage of some 150 years. Should the Congress now impose a strict limitation on investment activity?

If there are securities market problems the ABA believes they should be dealt with as such but not through a 5 percent limitation on holdings which has only the most tenuous chance of having any corrective impact on any market problem that may exist.

The Association also opposes the two percent leeway provision which would allow a pension manager to invest 2 percent of a pension trust in companies with capital less than $25 million without concern for the prudent man rule. This further erosion of the prudent man rule is not necessary because of the flexibility of the rule itself. We recognize that many investment managers have misconstrued the prudent man rule of ERISA and have become more conservative. The Association's Employees Trusts Committee has worked since September 1974, to convince pension managers that ERISA actually provides greater flexibility to the pension trustee than is enjoyed by the personal trust trustee. To a substantial degree we believe we have been successful. However, it might be very helpful if Congress were able in some way to restate its intent. The language of the rule as contained in ERISA should not be changed, however, since it was developed very carefully and really states well what the law should be. Any attempt to amend it by adding more specific language can only in the long run reduce its effectiveness.

Our concern over the 2 percent provision runs not only to the potential abuse which could be made of it but also to the standard which might be inferred from it. Would any investment over two percent in a company with less than $25 million capital automatically be deemed, presumed, or even suggested to be imprudent? Would any investment in such a company be tainted for personal trust investments? Should this occur the proposal would prove self-defeating.

The ABA supported the adoption of a Federal prudent man rule for many years before it was enacted. Time and again, we came before Congress to urge the passage of such a law. We strongly believe the interests of pension participants and beneficiaries as well as our nation's capital market needs will best be served by the flexibility of this rule without any arbitrary limitations or exclusions.

If specific problems exist or arise, they should be dealt with directly rather than indirectly through investment limitations or license.

Mr. Chairman, the association would be happy to work with you and your staff in developing solutions to any problems which may exist but we must oppose S. 285.

Senator CURTIS. Our next witness is Karen W. Ferguson from the Pension Rights Center.

STATEMENT OF KAREN W. FERGUSON, DIRECTOR, PENSION RIGHTS CENTER, WASHINGTON, D.C.

Ms. FERGUSON. My name is Karen W. Ferguson. I am the director of the Pension Rights Center, which is located at 1346 Connecticut Avenue NW., Washington, D.C.

Senator CURTIS. How old is the Pension Rights Center?

Ms. FERGUSON. Roughly 15 months old.

Senator CURTIS. By whom was it organized?

Ms. FERGUSON. It was organized by myself. Our seed money came from Ralph Nader. We have since gotten foundation money.

Senator CURTIS. Is it a Ralph Nader promotion?

Ms. FERGUSON. Ralph Nader saw a need for such a group and he gave us $10,000.

Senator CURTIS. A personal gift?

Ms. FERGUSON. Actually, it was a gift from the Center for Study of Responsive Law, of which he is a trustee.

Senator CURTIS. I do not mean to be critical. He has such a maze of organizations and transfer of funds. I want to get it straight.

Now, what other foundations or organizations have contributed to the Pension Center?

Ms. FERGUSON. Unfortunately not enough. We find that most foundations are not aware of the need for public interest groups in the pension area. The grants which we have gotten so far—actually we only have in hand one more, that is from the Lebensberger Foundation.

Senator CURTIS. Where is that located?

Ms. FERGUSON. I believe the president lives in Washington. As I recall, it is located in Massachusetts. Quite frankly, we have been corresponding only with the president.

Senator CURTIS. You may proceed with your statement.

Ms. FERGUSON. I would like to address both bills under consideration by this subcommittee, S. 901 and S. 285. I would like to turn first to the provision of S. 901 that provides for divided jurisdiction.

As we understand it, S. 901 was introduced to meet the problems of excessive paperwork and undue administrative delay. We certainly agree that these are serious problems which must be solved but do not think that the divided jurisdiction approach is the solution that best serves the interests of pension plan participants and beneficiaries.

The paperwork burden can be reduced without dividing jurisdiction. In fact, S. 901 has already had part of its intended effect: The Labor Department and IRS are reaching agreements on single forms and single filing dates.

The agencies have also apparently reached, and are reaching, agreements on the division of substantive issues. Neither these nor the more formal approach of S. 901 are, however, likely to reach the real causes for most administrative delays.

To mention what from the employee's perspective is the most egregious example of administrative delay: It will be more than 3 years after the enactment of the law before most participants receive booklets describing the terms of their amended plans. This has meant that many people have had to make important, irrevocable decisions—whether to take or leave a job, whether to retire—without the benefit of all-important information about their plans. Yet the reasons for this delay had nothing to do with dual jurisdicitions. In fact, in most instances delay in issuing regulations, granting exemptions or qualifying plans has been the result of intra- not inter-agency problems.

We have discovered that the root causes of delay are not the result of dual jurisdiction. Rather, they tend to be the result of intra-agency problems.

We find very frequently that delay is a product of tension within the agency between a policy staff which is under intense pension industry pressure to overlook or rewrite key provisions of the law and a legal staff which contends that the law ~~must be~~ implemented as written.

Another question is the question of priorities. Large pension groups get their exemptions first before smaller less powerful individuals.

There is also the not insignificant factor of staff turnover. We find time and again that the lower level staff expert on a particular regulation leaves to go to a pension industry job and then somebody else has to start in all over again. That is a very real cause of delay, and should not be discounted.

Our concern is that divided jurisdiction is not only not going to solve the real problems of delay and paperwork, but it also may cause serious new problems. The fact is that within a fairly short time, maybe even a year, most regulations will be issued, most exemptions granted, most plans will be qualified. However frustrating the delays may seem now, they are likely to become a matter of past history in the near future.

In our view, this subcommittee should not act precipitously, on the basis of what is essentially a transitional problem. Instead, it should look ahead to the role that the ERISA administrative agencies will be called upon to play in the future.

The key ERISA issues at that time are likely to be, first, the enforcement of existing standards; and second, the formulation of proposals for future legislative reform.

From the employees' point of view, divided jurisdiction in the enforcement area would be disastrous. To begin with, it would mean that all matters relating to their substantive rights—whether they are entitled to a pension, how much they are entitled to receive—would have to go to the IRS.

Although former Commissioner Alexander assured this subcommittee that the purpose of the IRS in the pension area is to safeguard rights, not to collect taxes, the fact remains that the IRS is just not oriented to helping employees who are not taxpayers. It is not oriented toward being an advocate for employee interests.

I note in my prepared statement that IRS enforcement would, in fact, involve another agency since, as presently structured, the IRS refers its district court litigation to the Justice Department.

What would actually happen under divided jurisdiction where an issue involved both vesting and fiduciary standards? Would an employee under the S. 901 scheme have to go both to IRS and to Labor to seek enforcement of his or her rights?

We have an example in our office. It is not too hypothetical. There is a truck driver who is covered by a pension plan which was recently amended after ERISA to provide extremely high benefits—$700 a month—to people who remained under the plan until age 65, and much, much lower benefits—as low as $273—to persons who have the same period of service, in this case 25 years, who happen to leave before age 65.

The truck driver takes the position that adoption of these provisions by the trustees was not solely in the interests of plan participants. He argues that these provisions were adopted to further the interests of the union and of the trustees and of the employees of the union and trustees. He points out that truck drivers cannot and do not work beyond the age of 57 for safety reasons, among other, and that the employees of the union and the employees of the trustees, who are covered by the plan, do.

This means that the union can determine who gets that very high benefit and who does not.

In addition, the driver takes the position that this violates ERISA. He contends that it violates the benefit accrual standards of ERISA.

Where would this person go, in this hypothetical situation, if he wanted to enforce his rights? Would he go to Labor for breach of fiduciary duty or would he go to IRS for enforcement of the benefit accrual provisions?

If small business people have trouble mailing in two forms to two different agencies, imagine the problems of an employee who actually has to negotiate with two different agencies to enforce his rights.

Divided jurisdiction would be equally prejudicial to employees' interests in securing much needed reforms in the private pension system.

ERISA was intended only to be a "first step" toward a more equitable retirement income system. The facts are that Government statistics show us that 56 percent of the full-time workers covered by private pension plans are on their jobs less than 10 years and that ERISA vesting schedules typically provide for 10-year vesting.

Prof. Dan McGill, of Wharton School, chairman of the Pension Research Council, has pointed out that in all Western European nations private pension systems mandate 5 year vesting or better, and he predicts that 5-year vesting will become a reality in this country within 10 years.

Under divided jurisdiction, who would take the initiative in studying the possibility or feasibility of 5-year vesting? Would it be the IRS who would have the actual experience with the inequities resulting from the operation of the vesting standards or would it be Labor which has the authority under the law, and the money, to do the studies?

The fact that we think divided jurisdiction would be a mistake from the employees' point of view does not mean that we support the type of consolidation of Labor and IRS jurisdiction proposed in H.R. 4340. In fact, we believe that consolidation in either the Labor Department or the IRS would be extremely detrimental to employee interests, but for very different reasons.

We see an Employee Benefit Protection Agency as the only solution of ERISA administration. Such an agency would have its sole mandate the advocacy of employee pension rights. Although an agency of this sort would require legislative action, it would meet all the objectives of the Executive Reorganization Act. Its immediate focus would necessarily be ERISA but in time it could serve as the cornerstone for a National Retirement Income Agency, an agency consolidating all agencies, commissions, and departments dealing with retirement income.

There is another all-important reason for this subcommittee to consider legislation to create an Employee Benefit Protection Agency. subcommittee.

For too long, consideration of the protection of the employee pension rights has been absurdly and unnecessarily divorced from consideration of the impact of pension fund investment practices. These two subjects are two sides of the same coin. They are different, but related aspects of the private pension system.

Contrary to Assistant Secretary of the Treasury Woodworth's suggestion to this subcommittee that pension fund investment practices are more properly the concern of the Securities and Exchange Commission, we believe that pension fund investment practices relate directly to employee pension rights. If pension fund assets are heavily concentrated in a relatively few institutions which invest in only 200 or 300 blue-chip stocks, that means that less favored larger companies, as well as medium and smaller sized companies unable to find necessary capital, may be forced to shut down. If companies shut down, the result is not only a loss of jobs but also, in most cases, a loss of pensions.

Also, if new companies are not able to come into existence, competition is that much less and increased demand for existing products would cause prices to go up. This directly affects employee pension rights.

What good is a fully vested, fully funded pension if pension fund investment practices have caused costs to skyrocket to such a degree that by the time the participant retires the pension no longer provides enough money for him or her to buy consumer goods, medical services, and housing?

An independent agency would be in a position to focus on pension fund investment practices as an integral part of its mandate to protect employee pension rights.

Turning to the specifics of S. 285, let me say that we support the objectives of this bill, although we are by no means convinced it would necessarily meet those objectives.

A technical problem we see with the modification of the prudent man rule—and we certainly hope that will become a "prudent person" or "prudent investor" rule—would permit trusts to make imprudent investments in smaller companies as long as those investments did not involve fraud or self-dealing.

Certainly this does not provide employees with adequate protection. It would mean that the Teamsters Central States pension fund could invest $30 million in a $25 million company just as long as the corporation was not a party in interest and no fraud was involved.

You can look at the history of the Central States Teamsters fund and find many questionable, imprudent arrangements that did not involve parties in interest. They involved persons with close associations with people connected to the plan, but those persons were not parties in interest and no fraud was involved.

We suggest that the language of section 3 of S. 285 be modified in such a way that it makes clear that although an investment will not violate the prudent person standard solely because it is made in a small company, other standards of prudence must be met.

The reason we do not think certainly section 3 will solve venture capital problems, is that we do not see that the very large financial institutions would have any institutional self-interest in going after venture capital investments.

We have been told that these banks and insurance companies deal in such large blocks of stock that they are not equipped to handle smaller investments. Also, they claim that pension fund management is so unprofitable that they just do not have the money to research smaller companies. It isn't worth their while to go look for the new Xeroxes of tomorrow.

We see both the 2-percent rule and the 5-percent limitation as important provisions, whether or not they realize their objectives. We think they are important because they represent a beginning—just as ERISA was a beginning. They would not solve the problems by any means.

Finally, I would like to turn to what is to us the most disturbing provision of S. 901, the provision that would eliminate the so-called laundry list of requirements in the annual report form and substitute Labor Department regulations.

No one who has watched the actions of the administrative agencies since the enactment of ERISA can have any doubt as to what the purpose and the effect of the proposed amendment would be. It would guarantee that plans would have to report far less information than is now required by section 103 of ERISA.

In our opinion, the result of such an amendment would seriously weaken the fiduciary standards of ERISA. I think I brought with me the statement from the House report on H.R. 2 that best summarizes the interrelationship of the disclosure and fiduciary provisions. It points out that—

> The safeguarding effect of the fiduciary responsibility section will operate efficiently only if fiduciaries are aware that the details of their dealings will be open to inspection and that individual participants and beneficiaries will be armed with enough information to enforce their own rights as well as the obligations owed by the fiduciary to the plan in general. (ERISA Legislative History at 3307)

Despite Senator Bentsen's statement that the intent of S. 901 was not to change fiduciary standards, we believe that that would be its end result.

We find implicit in the arguments—and we have been reading an increasing number of them—for restricting the contents of the annual report form the assumption that somehow this information is not of any value to employees. The contention is that employees are only concerned with what benefits they will get, how much and when. After all, their benefits are guaranteed. Why should they care how their money is managed?

You have heard from small business people who have to fill out the forms. I would like to share with you the experiences that we have had with employees who are trying to use these forms for precisely the purposes that ERISA intended. These are participants who are very concerned with how their money is managed. One of them is here today.

He is a retired management employee who, after more than 31 years of employment with one of the largest corporations in the country, retired on pension which is equal to something less than a fifth of his salary. He came to us with the proposition that his benefits might be higher if his plan were not getting such a very low rate of return on investments.

We, of course, immediately told him that everybody was getting low rates of return. We then told him that, after all, employer contributions could go down, if performance were improved. His benefits would not necessarily be increased.

He responded rather effectively. He pointed out that pension assets are long-term assets. He could not imagine how the plan was getting such a low return—in this case, it was something like 3.4 percent in 1972, going up to 4.5 percent in 1975.

He also pointed out that many plans, certainly large plans such as his own, have voluntarily increased benefits for retirees. Moreover, his pension fund contributions were funded largely by defense contract money so the employer really would not have the incentive to reduce contributions were investment performance to be improved.

We were intrigued, so we decided to take a closer look at his allegations. We began with a statement that had been made to him many, many years ago to the effect that the pension plan owned the company warehouse where he had worked. Before coming to us, he had looked through the D-2 forms. He had found no record of any party-of-interest transactions. We looked at the form 5500, the ERISA annual reporting form, and that also had no record of any such transactions.

On his own initiative, the participant then undertook to go to the county recorder of deeds where he discovered that title to the warehouse was held by a local bank as a trustee for a service corporation related to the company. With the help of a government agency, we began to unravel the mystery.

Why was it that he was told that the pension plan owned the warehouse, yet there was no record of any party-of-interest transaction?

What we discovered was a disguised party-in-interest transaction, what we believe to be a lease-back arrangement. The point is that the participant was right: The plan was not getting an adequate return on that investment.

From our point of view, what was significant is that he could never have found out about the lease-back arrangement had he not had independent knowledge of the plan's "ownership" of the property. The forms, both the D-2's and the 5500, did not contain this important information.

We then looked at another of his allegations. He said, look at the very high turnover of assets here. Maybe that is why we are getting such a poor return on investments. In fact, a third of the plan's assets were sold and something more than that was bought each year.

Of course, we immediately looked for brokerage commissions, evidence of possibly unreasonable administrative expenses. Our only tools now were the D-2 forms and the form 5500. There was no record of any brokerage commissions. In fact there was no record of any expenses whatsoever anywhere on the form. We learned that what the company was doing was taking the position that it could avoid disclosing any administrative expenses by the simple expedient of saying it was paying for the expenses, not the plan.

Senator BENTSEN [presiding]. Is that true?

Ms. FERGUSON. That is the position that they are taking.

Senator BENTSEN. Is it true?

Ms. FERGUSON. My point is, all we have, all that the participant has, is these forms. This is what we see. Here is an individual who is trying to do what he is supposed to do under the law, which is to make sure that his money is managed prudently and in his interests, and it is virtually impossible.

I will mention one more thing. At our suggestion, he talked to an actuary with long years of experience in the senior area to see whether his impressions were correct. The actuary confirmed that it looked as though there were some questionable transactions. Then he, together with the participant, discovered that in 1974 something like 29 percent of the plan's assets were involved in unsecured short-term loans.

We were intrigued by this and waited with eagerness to find out what these loans were—after all, the form 5500 was supposed to tell us, on the schedule of assets, what these investments were.

The first thing we discovered in looking at the form 5500 is it provided less information than the D-2 form in this respect: There is no breakdown that we could find in the form 5500 between secured and unsecured loans. The next thing we discovered was there was no mention of these unsecured loans; although they were on the D-2 form for the last day of 1974, they had disappeared by the first day of 1975.

There are other omissions. I am mentioning these here to point out that what is needed is not less detail. If the fiduciary standards are to work, there is a necessity for more detail. And, of course, the Labor Department already has the authority to provide that detail.

We strongly urge that section 3 of S. 901 not be adopted.

I might add that both the participant and I would be happy to answer questions about the issues I have just raised. I hope we have interested some Government agencies in pursuing this investigation so that perhaps more information will come to light.

Senator BENTSEN. I appreciate your testimony. I apologize for not being here earlier. It is the same old problem we have in the Senate, two things taking place at the same time.

I, too, want to protect the ability of the participant to obtain needed information but also want to try to achieve a balance and not kill a bunch of these plans by overloading the reporting that has to be done for small companies.

Under my legislation, whenever the Pension Rights Center, for example, wants information a pension participant could request it, and could get it. I am trying to find a balance where a participant would have access to information if he so desires but there would not be an excessive reporting burden on smaller firms.

I am concerned about establishing one single pension agency. There would be a loss of time in the set up of the agency. It would require the transfer of the people with expertise since I assume you would not start off with all new employees. The administration is in a state of quandry now in getting out ERISA regulations, and I am afraid that we would add substantially to existing confusion if a new agency were established.

During these pension hearings we have solicited testimony both for and against my proposals because that is the only way we can improve this bill by trying to meet some of the problems and some of the challenges to it, and your testimony has been helpful and I appreciate it.

Thank you.

[The prepared statement of Ms. Ferguson follows:]

STATEMENT BY KAREN W. FERGUSON

Mr. Chairman, members of the subcommittee, I am Karen W. Ferguson, director of the Pension Rights Center, a public interest group organized to protect employee pension rights.

S. 901. DIVIDED JURISDICTION

S. 901 was introduced to meet the problems of excessive paperwork and undue administrative delay. We agree that these are serious problems which must be solved but do not think that the divided jurisdiction approach is the solution that best serves the interests of pension plan participants and beneficiaries.

The paperwork burden can be reduced without dividing jurisdiction. In fact, S. 901 has already had part of its intended effect: The Labor Department and IRS are reaching agreements on single forms and single filing dates.

The agencies have also apparently reached, and are reaching, agreements on the division of substantive issues. Neither these nor the more formal approach of S. 901 are, however, likely to reach the real causes for most administrative delays.

To mention what from the employees' perspective is the most egregious example of administrative delay: It will be more than 3 years after the enactment of the law before most participants receive booklets describing the terms of their amended plans. This has meant that many people have had to make important, irrevocable decisions—whether to take or leave a job, whether to retire—without the benefit of all-important information about their plans. Yet the reasons for this delay had nothing to do with dual jurisdiction. In fact, in most instances delay in issuing regulations, granting exemptions or qualifying plans has been the result of intra-not inter-agency problems.

Not infrequently the delay is a product of tension between a policy staff subjected to intense pension industry pressure to overlook or rewrite key provisions of the law and a legal staff which contends that the agency has an obligation to adhere to the law as written. In other cases it is a question of priority, large pension industry groups get their exemptions handled before smaller, less powerful individuals. And there is also the not insignificant factor of staff turnover. Time and again in both Labor and IRS we have discovered that the key lower level staff attorney who has become an expert in a particular area has left the agency, usually to a pension industry job.

Divided jurisdiction will not only not solve the problems of delay, it is also likely to cause serious new problems. Within a fairly short time, possibly within 12 months, most regulations will have been issued, most exemptions will have been granted and most plans will be qualified. However frustrating the delays may be now, they are likely to become past history fairly soon.

In our opinion this subcommittee should not act precipitately on the basis of what is essentially a transitional problem. Instead, it should look ahead to the role that the ERISA administrative agencies will be called upon to play in the future. Then the key ERISA issues are likely to be the enforcement of existing standards and the formulation of proposals for future legislative reform.

From the participants' point of view divided jurisdiction in the enforcement of ERISA would be disastrous. To begin with, it would mean that in all matters relating to their substantive rights—whether they are entitled to a pension and how much—they would have to go to the IRS. Former Commissioner Alexander has assured this subcommittee that the purpose of the IRS in the pension area "is to safeguard rights, not to collect taxes," but the IRS is not oriented toward assisting employees, who are not taxpayers, or actively advocating employee rights. In fact, the active involvement of the IRS in enforcing participation and vesting standards would necessarily involve still another agency, since at least as presently structured the IRS refers all district court litigation to the Justice Department.

And what would happen where an issue involved both vesting and fiduciary standards? Would an employee under S. 901 have to go to both IRS and Labor to seek enforcement of his or her rights?

Take, for example, a not-too-hypothetical situation under consideration in our office. A truckdriver is covered by a pension plan that provides for $700 in monthly benefits for persons with 25 years of service who work until age 65. The plan provides as little as $273 (up to $525 for persons retiring in 1996) for persons with 25 years of service who leave the plan before age 65. The terms of the plan are set by the plan trustees. The driver takes the position that in adopting the $700 in-service benefit the trustees were not discharging their duties solely in the interests of participants. He points out that most truck drivers cannot drive beyond age 57 and that the only persons who will benefit are the trustees, employees of the Union and the Union itself since it can offer nondriving jobs to favored employees and so determine who gets the $700 benefit. The driver also takes the position that the $700 violates the benefit accrual requirements of ERISA. Under divided jurisdiction where would he go to seek help in enforcing his claim? To Labor for breach of fiduciary duty or to IRS for enforcement of the benefit accrual requirements? If it is burdensome for a small business person to mail two forms to two government agencies, think how much more burdensome it would be for the truckdriver to enforce his rights.

Divided jurisdiction would be equally prejudicial to employees' interests in future reforms of the private pension system. ERISA was only intended to be a "first step" toward a more equitable retirement income system. Rigidly segmenting administration of the law will diminish the impetus for future "steps." Professor Dan McGill has noted that all Western European countries have private pension systems that mandate full vesting after at least 5 years and has predicted that 5-year vesting will become a reality in this country within 10 years. Under divided jurisdiction which agency would take the initiatve in studying 5-year vesting? The IRS would have first-hand experience with the inequities resulting from the operation of the present vesting schedules, but would it take the lead or would the Labor Department which would still have the authority (and appropriations) under the law to conduct such studies?

The fact that we think divided jurisdiction would be a mistake does not mean that we think that the Dent-Erlenborn bill, H.R. 4300 would better serve employee interests. In fact, as I noted in my testmony before the House Labor Standards Subcommittee last month, consolidation in either IRS or the Labor Department would be equally detrimental to employee interests—for different reasons.

THE NEED FOR AN INDEPENDENT EMPLOYEE BENEFIT PROTECTION AGENCY

We see an independent "Employee Benefit Protection Agency" as the only solution to the many problems of ERISA administration. In my testimony on H.R. 4300, I outlined the structure of such an agency and its mandate—which would be to serve as a much needed advocate of employee interests.

Such an agency would require legislative action, but would meet all the objectives of the Executive Reorganization Act. Although its immediate focus would necessarily be ERISA, in time it could serve as the cornerstone for a National Retirement Income Agency, an agency consolidating all agencies, commissions, and departments dealing with retirement income, possibly eventually—in the very far future—even encompassing the retirement income aspects of social security. Certainly one of the greatest needs of this country today is a national retirement income policy. One the one hand we have complaints that some retirees are getting too much—These are people who are getting a private pension and often a civil service and/or military pension as well as social security. On the other hand, what we hear most is that the vast majority of retirees are getting too little—They are barely subsisting on embarrassingly inadequate social security payments.

There is another all-important reason for this subcommittee to consider legislation to create an Employee Benefit Protection Agency. That reason is implicit in S. 285.

For too long consideration of the protection of employee pension rights has been absurdly and unnecessarily divorced from consideration of the impact of pension fund investment practices. These two subjects are two sides of the same coin, different but interrelated aspects of the private pension system. There is already increasing recognition that an employee's pension is likely to be the largest investment of his or her lifetime (Peter Drucker, *The Unseen Revolution*). A recent American Enterprise Institute Study pointed out that for most employees it also is likely to be the most efficient form of investment (Norman Ture, *The Future of Private Pension Plans*). Employees themselves are increasingly recognizing that they have a legitimate interest in how well "their money" is being invested, that improved performance can mean improved benefits. In the words of one commentator: Actuaries compute that for every one percent increase in returns on the trust portfolio, a pension can pay out between 10 and 20 percent more in benefits. The variation depends on age, sex and other factors relevant to the covered group. Thus, if an overall yield can be boosted from 3½ percent to 5½ percent for example, benefits paid to pensioners can be increased by one-third in many cases. Noel Arnold Levin, Labor-Management Benefit Funds at 63.

S. 285 focuses on is *where* pension funds are invested. Contrary to Assistant Treasury Secretary Woodworth's suggestion that pension fund investment practices are more properly "the concern of the Securities and Exchange Commission," this subject relates directly to the protection of employee pension rights.

If pension fund assets are heavily concentrated in a relatively few institutions which invest in only 200 to 300 blue chip stocks, that means that less favored larger companies as well as medium and smaller sized companies unable to find necessary capital, may be forced to shut down. If so, the result is not only a loss of jobs but also in most cases a loss of pensions. Similarly, if new companies are not able to come into existence, competition is that much less and increased demand for existing product can cause prices to go up. This directly affects employee pension rights. What good is a fully vested fully funded pension if pension fund investment practices have caused costs to skyrocket to such a degree that by the time the participant retires, the pension is no longer sufficient to purchase the essential consumer goods, medical services and housing.

An independent agency would be in a position to focus on pension fund investment practices as an integral part of its mandate to protect employee pension rights. It could also fully explore other related concepts such as that of expanded stock ownership in a pension context and the interrelationship of pension and mandatory retirement age problems.

S. 285 DECONCENTRATION OF PENSION FUND INVESTMENTS.

Turning to the specifics of S. 285. First, an objection to the phrasing of Section 3 "Modification of the Prudent Man Rule." As that Section now reads it would permit trusts to make imprudent investments in smaller companies, as long as those investments did not involve fraud or self-dealing. This does not provide employees with adequate protection. It would, for example, permit the Teamsters Central States Southeast Southwest Areas Pension Fund to invest $30 million in the securities of a mafia held corporation as long as the corporation was not a party-in-interest and no fraud was involved. Extrapolating from the past history of that Fund it would be possible as the provision is drafted to make an imprudent investment in a corporation controlled by the lawyer for the Union President or a former consultant to the Fund since these persons are technically not parties-in-interest and no fraud is involved. We suggest that the language be modified so that it states that a trust does not violate the fiduciary responsibility provisions "solely because an investment of such assets by a fiduciary of the trust is made in the securities of a corporation with a capital account of less than $25,000,000" etc. The provision should specifically state that the investment must be prudent in all other respects.

Quite frankly, we do not think Section 3 will solve the venture capital problem. Given the long-term nature of pension fund money it would not seem imprudent for pension fund trustees to invest small amounts of money in new companies that promise high returns at some risk. In fact, the prudent individual investor often does precisely that.

Our guess is that the institutions investing the great bulk of pension plan assets—and which have the degree of sophistication necessary for such investments—just don't have the incentive to invest in small companies or venture capital firms. Certainly the capital starvation problem existed long before the ERISA prudent person rule. Senator Bentsen was concerned about this problem when he noted, on July 24, 1976, in opening the first set of hearings on institutional investment practices: today there is increasing concern that institutional investment is seriously distorting . . . equity markets and making it exceedingly difficult for small-and medium-sized firms to obtain the funds they need for expansion.

The large banks and insurance companies apparently customarily deal in large blocks of stock that can be sold easily and are not equipped to handle smaller investments. Moreover, their margin of profit from the management of pension assets is so minimal that they claim that they cannot afford the additional expense needed to research smaller companies. It's not in their institutional self-interest. At the other extreme you have the independently trusteed plans, such as those surveyed by the International Foundation of Employee Benefit Funds, who tend not to be professional investors. Their move toward blue chip stocks was one of the anticipated and desired results of ERISA.

Given the probable long-range benefits to participants, we have no objection to the 2-percent rule nor to the 5-percent limtiation. At the same time, we consider these to be only very modest proposals, like ERISA, representing only a beginning.

S. 901 ELIMINATION OF ANNUAL REPORTING REQUIREMENTS

In conclusion I would like to return to S. 901 and a provision that we consider to be potentially the most detrimental to employee rights of any proposed to date. I am referring to section 3 and to that part of section 3 which would eliminate the "laundry list' 'of items now required to be included in ERISA annual report forms, replacing it with Labor Department regulations.

No one who has watched the actions of the administrative agencies since the enactment of ERISA can have any doubt as to what the purpose and effect of the proposed amendment would be. The Labor Department's policy of "flexibility" guarantees that plans would have to report far less information than is now required by section 103 of ERISA.

Implicit in most arguments in favor of restricting the annual reporting requirements is the assumption that the information serves no useful purpose. The Labor Department can always get the information on request and, the argument goes, employees are only concerned with whether they will get a benefit and how much they will get. This presupposes that an employee is not concerned with what the plan does with his or her money since in most cases plan benefits are guaranteed.

I would like to take a minute to refute that assumption. Our experience has been that employees are concerned about how their money is invested. We have discovered that more, not less, information should be required if fiduciary responsibility standards are to be effective.

One of our projects is the preparation of guidelines to assist employees interested in examining their plan's investment practices. In part to educate ourselves, we have begun looking into the operations of several plans. The most interesting and instructive, in terms of additional information needed on the form 5500, is the salaried employees' plan of one of the nation's largest corporations.

The participant who brought the plan to our attention is a retired management employee who, after more than 31 years of employment with the company, is retired on a pension of $3,900 to supplement the $4,800 he receives in social security benefits. His retirement income is a little over two-fifths of the amount he was earning when he retired in 1975. (His company pension is less than 20 percent of his salary.) He takes the position that his plan is getting an unreasonably low rate of return on its investments—3.4 percent in 1972 to 4.5 percent in 1975—and that if his plan assets were more prudently managed there is a good chance that his benefits could be increased. We pointed out to him that there is an equal chance that company contributions could go down. His response was to point to benefit increases for retirees under other plans and to the fact that substantial amounts of the company's annual pension contributions come from defense contracts, so the company would have little incentive to reduce contributions.

Intrigued, we started to take a closer look. At the participant's suggestion we began with a statement made to him that the pension plan owned the company warehouse where he had worked. We searched through the D-2 forms and the form 5500 but found no record of any party-in-interest transactions. The participant then undertook to go to the county Recorder of Deeds and discovered that title to the warehouse was held by a local bank as trustee (for a related company). With the help of a government agency we began to unravel the mystery. What we now seem to have uncovered is a disguised party-in-interest leaseback. The participant was right. The plan was not getting a reasonable return on at least this one investment. The point to be made here is that without the participant's independent knowledge of the plan's involvement, this transaction would never have been uncovered. There would have been no way for the participant to have found this information in the form 5500.

The participant next suggested that another reason the plan may have been getting such a poor return on investments was that it was turning over an excessive amount of plan assets each year. The plan could be paying large amounts in brokerage commissions. Although the turnover figures were clearly stated on the D-2 and the form 5500—from 27 percent to 42 percent of the plan's assets were sold in the years 1972 through 1975 and larger amounts were purchased—there was no reference to brokerage commissions. For that matter there were no references to any plan expenses at all. There was no way to determine from the form 5500 or the earlier forms what amounts, if any, were paid to the plan trustee, actuary or accountant. (In fact, the only way we discovered the identity of the plan trustee was through the notes appended to the accountant's report.) The plan is apparently taking the position that it can avoid disclosing any expenses on the form 5500 by the simply expedient of having the company pay all expenses. The participant has an interest in administrative expenses whether the company or the plan pays those expenses. Unreasonable administrative expenses mean that less of the money allocated by the company for pension costs is available for the payment of benefits.

At our suggestion the participant discussed his allegations with an actuary who has had extensive experience in the pension area. The actuary confirmed that the participant's findings suggested breaches of fiduciary responsibility. The actuary also pointed out the existence of large amounts of unsecured loans reported in the pre-ERISA D-2 forms. In 1974 the unsecured loans amounted to about 29 percent of the total plan assets. We then discovered that, unlike the D-2 form, the form 5500 had no provision for a breakdown of secured and unsecured loans. In addition, the form 5500 for 1975 did not show what happened to the unsecured loans shown as outstanding at the end of 1974. These loans seem to have disappeared between December 31, 1974 and January 1, 1975.

There are other omissions. I mention these merely to illustrate the fact that rather than providing too much detail, the Section 103 laundry list does not provide nearly enough. Fortunately, ERISA section 104 gives the Labor Department the authority to remedy these deficiencies and others that may come to light in the course of this and other efforts by participants to determine whether their plan monies are being managed in their interests.

Senator BENTSEN. Our next witness is Mr. Arthur Fox, counsel for PROD, Professional Drivers Council.

STATEMENT OF ARTHUR FOX, COUNSEL, PROD, INC.

Mr. FOX. Thank you, Mr. Chairman, for the opportunity to testify on behalf of PROD. First, I should mention that I am an attorney associated with the Public Citizen Litigation Group. I serve as counsel to PROD on whose behalf I am testifying. PROD is a nationwide Teamster rank-and-file reform organization that has been in existence for 6½ years.

I have submitted prepared remarks which I will not repeat. I have also prepared some notes which I will not follow in the interest of brevity, and to avoid repeating what has already been said by earlier witnesses. If you wish to interrupt me, please feel free.

I would like first to address S. 285, the Tax-Exempt Private Pension Investment Act. We endorse most enthusiastically that provision which is designed to eliminated undue influence over corporations by pension fund managers for all the reasons that have already been cited on behalf of that particular provision, undue influence, stock market vicissitudes, et cetera.

I submit that possibly one of the reasons the stock market has been slow to recover after the recession in the earlier part of this decade may be due in part to the fact that some smaller investors are afraid they may take a bath as a result of dumping by those who hold huge quantities of stock. In this day and age, they are primarily large trust fund and pension fund managers. However, there is an additional reason why we, at least, support that particular provision, particularly the philosophy that it seeks to promote.

There is, in this country, a rather crazy quilt of interwoven business relationships. Money, we must admit, equals power and influence. Not all business managers are immune to economic pressures and not all pension managers are completely beyond reproach.

In managing their approximately 240 separate pension funds, the Teamsters have frequently invested the assets of those funds in a fashion calculated to secure political rewards. Indeed, over the years, as Teamster reformers have approached members of the business and even political communities asking for assistance and support, too frequently they have been greeted only by a rather stony silence. It is possible, whether businessmen and politicians are even aware of the fact they are a second or third cousin-beneficiary of a Teamster investment, someone may lean on them and call some of their political I O U's.

We believe, however, that there is no reason why there should be an arbitrary $150 million corporate, or arbitrary $1 billion pension, cutoff if, indeed, the philosophy is a worthy philosophy. We submit to the committee that it ought to be applied perhaps on a graduated basis on down to smaller pension funds and smaller corporations.

The Teamsters have only two pension funds, the Western States and the Central States pension funds, which exceed $1 billion, to my knowledge. The Western States fund has been managed by Prudential Insurance Co., and now the Crocker National Bank has taken over asset management of the Central States fund. However, there are another 238 pension funds concentrated primarily in the Northeastern United States where the managers may continue, possibly in spite of the fiduciary standard, to invest their funds in a fashion designed to gain control of corporations.

With respect to the second provision in S. 285 which would relax, if not eliminate, fiduciary duties, we are deadset opposed. I do not think that any pension fund——

Senator BENTSEN. Which provision?

Mr. FOX. Section 4, the modification of the prudent man rule.

We are opposed to that section because we do not feel that the managers of any pension fund, be it a large one or small one, ought to feel that they could treat any portion of their funds as "mad money."

I believe, and I would in this sense adopt the testimony of Mr. Moran, that the current fiduciary duty standard does provide the necessary latitude to managers of pension funds to put a certain percent of their funds in smaller corporations that may be considered somewhat more venturesome.

In fact, let us face it, some of these smaller, more venturesome corporations also hold out the prospect of much higher return on their money and if, indeed, they do their homework and do investigate these funds, the courts will sanction their loans as long as it was prudent to have made the investment at the time that they made it.

The courts may go on to say, however, that there is a need to monitor that loan more closely and bail out if the company goes down.

Nevertheless, while greater supervision by pension fund managers will undoubtedly cost them slightly more money, the prospective benefits to the beneficiaries; namely, high income, would hopefully offset these costs.

Also, pension fund managers will always be second-guessed anytime a corporation goes under, whether it is Penn Central or the XYZ Widget Co. The fact is managers will always have to justify their investments if they are called to task. If they have done their homework, if they can demonstrate that they have done their homework, I do not believe they will be in trouble.

Moreover, if they can say to a court, "Look, we have 18 companies, small companies that are valued at under $25 million in which we have invested and only one of them has gone down the tubes," they should be in fine shape.

Senator BENTSEN. That may be what you think, but all I can do is cite you the numbers and cite you the survey and cite you the fact we had venture capital people right here. They said they previously had pension funds for relatively a large amount of money and that money had dried up since ERISA and the prudent man rule. I can just tell you how it is out there, what is actually happening, not what your legal opinion of it is, or some other lawyer's legal opinion, or what some judge may decide.

Mr. FOX. I am very, very sensitive to that, Senator. I am not sure that that problem will necessarily go away if section 4 should be enacted. Pension managers will still, I think, feel that they have to investigate loan applicants and not just give out their money on a first-come, first served basis. This is still going to require a greater investment in personnel on their part.

Senator BENTSEN. No question about that.

Mr. FOX. Personnel will cost money and they still may shy away from that in the interests of preserving such expenditures.

Senator BENTSEN. I can only tell you that before ERISA they did otherwise and the funds were there and they have testified to that, several witnesses.

Mr. Fox. Mr. Moran also made a very valid point, I think, when he suggested that the Congress might, without tampering with the existing prudent man rule, express a sense of the Congress or a resolution to the effect that it did not intend to have his fiduciary standard drive pension funds out of the money market. The Congress might even say it expected that managers might, particularly because of the earning potential of some smaller Xeroxes or Polaroids, invest in some more venturesome businesses. Indeed, an argument can be made that the only way to comply with the prudent man rule would be for managers to invest a certain percent of their assets in some corporations that might offer the opportunity for very high gains without tampering, however, with that prudent man rule. Just a suggestion.

I will now, if I may, just briefly address S. 901, the Pension Simplification Act. I think we must first remind ourselves that pension managers are not just the Manufacturers Hanovers, the Morgans, the First National Cities or Prudential Life Insurance Co's. There are thousands of funds out there that were created under the Taft-Hartley Act that are managed by an equal number of union and management trustees. Many, if not most, of these individuals are from backgrounds where they were not accustomed to having large incomes.

These individuals, neither by experience, nor by training, know how necessarily to invest those pension funds. Indeed, it was largely because of the abuses by these kinds of individuals, not the kind that principally have been called to testify here, that ERISA was enacted in my opinion, at least in the form that it currently is.

Indeed, the Teamsters in particular have been subjected to these particular kinds of abuses. We believe that one of the most important protections of ERISA currently is the disclosure provision. It provides the encouragement, inducement, whatever you want to call it, to these other kinds of pension fund managers to shape up, to fly straight. In other words, ERISA has had a terribly, terribly valuable prophylactic effect that simply cannot be over-emphasized. If these managers recognize that some experts, more expert possibly than they, have the capacity to look over their shoulder because they, too, have sufficient information to second-guess managers, then, and in some cases only then, will managers run their funds honestly. I do not think that you would have proposed repealing the existing statutory reporting requirements had you not felt that the Secretary of Labor, or some other future Secretary, might promulgate rules that were less specific, less detailed, less, perhaps burdensome. Indeed, there are two good reasons to support such a conclusion. One, any student of the executive branch of Government realizes that over the years regulators slowly but surely end up, at least in part, regulated by the industries or industries or interest groups that they are supposed to regulate. They hear primarily from those people.

There are not many Ralph Naders or Karen Fergusons that can, in fact, handle complaints by the many thousands, millions of pensioners in this world, and also to make regular appearances before the Department of Labor. Nor do they have the political clout to successfully lean on the Department.

Second, the Department of Labor has historically been the division of the executive branch which has been most sensitive to the interests of institutional organized labor. Once again, we must remember, at least with respect to the Taft-Hartley funds, one-half of the trustees and many of the administrators of these funds are the very labor union officials with whom the Department of Labor has such close alliances. I would hasten to add that all indications are that this Democratic administration and Labor Secretary Marshall have been doing, at least thus far, a very admirable job. There are however no guarantees that future administrations, after this all becomes very stale, will do an adequate job.

Senator BENTSEN. Do you not think that we can cut down the reporting requirements without denying the participant the right to the information?

All are subject to Government audit or suit by participant.

Mr. FOX. Senator, participants, in the first place, are not very likely to sue. To bring a suit is an extraordinarily expensive proposition in this day and age. Second, most participants are not sophisticated enough in the various complexities of these huge financial institutions to know even how to begin to locate those individuals who have the information they might need.

I do agree with you that we should continue to focus very carefully on any regulations or requirements that may be duplicative, or inconsistent, or unduly burdensome in fact, while always keeping in the back of our minds the purposes that these regulations were designed to serve.

There is no doubt that in those pension funds that have been and will be prudently and honestly managed, the reporting requirements may create unnecessary burdens. Those are not, however, the only kinds of funds out there in the real world. There are so many smaller funds that do need this kind of prophylactic, supervisory role to be played by some administrative division of the executive branch of Government.

The only way to insure that there will be adequate detail in these reports is to put it in the statute. Maybe some years from now we may want to reconsider these requirements. Right now, the propensity in the executive branch to soften and to yield to regulated class is so great that we cannot afford to give blanket authority to anyone, whether it is the Secretary of Labor or perhaps any department or agency in the executive branch of government, to establish and maintain adequate reporting requirements.

With respect to the elimination of duplicative efforts by separate agencies, I would subscribe, at least in part, to the remarks made by Ms. Ferguson to the effect that it really would be most advantageous to pool all authority for implementing and enforcing ERISA in a single agency. I do not feel that I have the wisdom to say whether there should be a new agency. You, yourself, have mentioned that there would be more growing pains due to the transition which would occur when pooling the authority in a new agency. Very possibly it is the kind of decision that ought to be left, at least tentatively left, to President Carter in his efforts to reorganize the executive branch of Government.

I think there are more reasons that have yet to be mentioned why a single agency concept is the only one that would ultimately be workable. I spent 4 years working in an agency, and 5 years monitoring agencies, my entire professional life. My experience has taught me that there are inevitably a lot of jealousies between agencies, that they have great difficulty coordinating their efforts between one another. With two agencies sharing authority, you do not have a single boss and a clear chain of authority where jobs can get done. Bureaucrats have spent too much time holding each others' hands and salving one anothers' egos in order to get something done.

Furthermore, there are frequently inabilities for the left hand of one agency to understand what the right hand of another ought to be doing, or vice versa. If one agency were to write standards which another agency is supposed to understand in order to enforce, do they really understand them?

Suppose they really do not believe, or the second agency does not really subscribe to the standards that were written by the first agency, in principle or whatever? Once again, until there is a single authority that says, do it, it does not get done.

Finally, we oppose the provision in S. 901 which would permit funds to go to courts for declaratory orders in order to force the Government to grant exemptions and grants. We, too, are sympathetic with those funds which have applications that have ~~not~~ been acted upon. Where exemptions would truly be in the best interests of the beneficiaries, delays are most regrettable. It conceivably is inexcusable that this should take place.

I submit, however, that the log jam we face today, we will not face in the future. Personnel are being detailed to the writing of regulations right now that in the future would be available to process of applications, No. 1. No. 2, many of there applications are one-shot affairs filed in order to bring a particular pension fund into compliance with the new complex law that we are gearing up.

I therefore believe that the rate that these applications are arriving in Washington will decrease steadily over future years, and that this kind of drastic surgery that you are proposing to perform is unnecessary and might even be dangerous, at least in the near future. It may hamstring government, and it may lead to the securing of exemptions or variances which, in fact, are not deserved.

In conclusion, I would just say on behalf of the many thousands, indeed there are in excess of 10,000 dues paying members in PROD alone, that is ever so necessary that we realize how delicate or ticklish the job or mission we are embarking upon. We must be extraordinarily sensitive to the people that ERISA was designed to serve, not the managers but the beneficiaries.

I thank you very much, Senator.

Senator BENTSEN. On that point, I very strongly agree. I was the author of the pension bill that passed this committee and I still take pride in that, despite all of the criticism of ERISA, that some 30 to 40 million Americans have security when they reach retirement, know that those funds are going to be there.

And we put in some relatively tough funding and vesting provisions to take care of those people that were not doing a job for their employees. But I am also deeply concerned in some instances that we have the tendency to try to govern for the worst case and we are killing off a bunch of the small plans.

It is no problem with the giant corporation, with their lawyers and accountants. They can manage it. But time and time again, you get a firm that has 40 to 50 employees a small company. They just throw up their hands and say, let us forget it, the plan goes out of existence for a variety of reasons. I think one of the reasons is the incredible amount of paperwork given to some of these small plans.

Mr. FOX. If I may address myself to that, I do believe that we may find in the future while small employers terminated their preexisting pension plans, they may ultimately pool their interests in larger pension plans. In fact, their employers may not, in the ultimate sense, suffer. I hope that will be the case.

Senator BENTSEN. That may be, but I know how tough it is to talk an employer into putting one of these into effect. Often, if one goes out and have to start over again, meanwhile, a lot of employees have suffered.

If you are talking about a new agency—there is no way you can get IRS totally out of it, because they will always be involved in seeing that there is reasonable compensation and that type of thing, if there are deductions, and to see that someone is not stacking the deck to take care just of the owner-employee.

Mr. FOX. The President might take that into account and decide to vest the responsibility for this agency with the IRS.

Incidentally, I forgot to mention and I want to call to your attention to one provision in S. 285, section 3, which is a modification of the prudent man rule. As I understand your intent, Senator, it was to limit the total percent of the pension fund that could be used as mad money, if you will permit me that expression, to 2 percent.

Senator BENTSEN. I do not really want to permit you that expression.

Mr. FOX. As I read that particular provision, I see a dangerous ambiguity which would permit a manager of a pension fund to make numerous 2 percent loans to small corporations. In line 4 on page 6 of the current bill it says, "The securities of any corporation with a capital account of less than $25,000. . . ." If you would simply make the word, "corporation" plural, it would be clear that no more than 2 percent of a fund's total assets could be invested in such corporations.

Senator BENTSEN. That is certainly the intent. I appreciate your bringing that to our attention.

Well, thank you very much. We appreciate your testimony. It has been very helpful to us.

[The prepared statement of Mr. Fox follows:]

STATEMENT OF ARTHUR L. FOX II

Thank you for the opportunity to share with you some of our thoughts concerning the proposed Pension Simplification Act (S. 901) and the proposed Tax-Exempt Private Pension Investment Act (S. 285).

We share your concern in protecting pension plans from costly efforts to comply with unnecessary, inconsistent or duplicative Government regulatory requirements. After all, pension plans exist for one singular purpose and we cannot afford to lose sight of the fact that it is to provide vital monetary security for our retired senior citizens. Health and welfare funds provide an equally vital financial protection for working men and women. The more money a pension or health plan must expend to perform secondary functions, such as preparing and filing duplicative reports or trying to decipher inconsistent government regulations, the less money there will be left to make payments to participants or beneficiaries.

Similarly, we share your concerns reflected in S. 285 that a prerequisite for a healthy, growing and competitive economy is access to capital by small, growing businesses which may not yet have a triple A rating by Dunn & Bradstreet. And there can be no doubt that major sources of capital today are private pension funds. If their capital simply cannot be made available to small businesses due to the operation of a statutory fiduciary duty standard or any other legal, political or economic phenomenon, and if small businesses cannot obtain capital from other sources, then our economy may well atrophy. Needless to say, workers would suffer if this should come to pass.

Thus, while PROD supports the overall objectives of these two bills, we would like to offer some criticisms directed at several of their provisions which we do not believe would be in the best interests of either pension fund participants or beneficiaries. I would like first to address myself to S. 901, the Pension Simplification Act.

S. 901

This bill would simplify the reporting requirements of the Employee Retirement Income Security Act (ERISA), substantially eliminate dual jurisdiction by the Department of Labor and the Internal Revenue Service (IRS) in the administration of ERISA, and eliminate delays in the processing of applications for exemptions and variances from ERISA requirements. While all of these specific goals seem to be laudable on their face, we seriously question whether the procedures set forth in S. 901 would ultimately serve the best interests of the participants and beneficiaries of pension, health and welfare funds. And, we must continually remind ourselves that these are the primary interests which any amendment of ERISA must ultimately advance.

Of course, we agree that the Congress should avoid imposition of any requirements on such funds which result in the expenditure of precious assets in order to comply with truly unnecessary requirements of ERISA or the regulations adopted by either the Department of Labor or IRS. Therefore, we must be careful to analyze any statutory requirements we may wish to modify in light of the goals which they are designed to promote, versus the costs of compliance, and then ask ourselves whether participants and beneficiaries are likely to come out ahead or behind.

In the same vein, we must be careful not to credit automatically any and all representations which may be made by those responsible for administering such trust funds whose jobs may have been made considerably more complex and demanding as a result of the enactment of ERISA. It is important to remember that ERISA would never have been enacted, at least not in its present form, but for the rather egregious abuses of a substantal number of employee trust fund managers. Indeed, a substantial percent of these funds, particularly those created under the Taft Hartley Act (29 U.S.C. § 186(c)), are managed by individuals who have never enjoyed large incomes and who have neither experience nor training in the management of huge sums of money to which they suddenly have ready access. To many, this pot of gold presents an enormous temptation which only the most scrupled and self-disciplined can resist.

Potential weakness of section 4

Teamsters in particular have suffered from these kinds of abuses by the trustees of their many Taft-Hartley funds which, by the way, happen to proliferate the northeastern part of the country in absolute numbers, if not net worth. Indeed, many trustees of Teamster funds would continue to abuse their fiduciary responsibilities to their participants and beneficiaries but for the prophylactic effect of the ERISA disclosure requirements set forth in section 103 of that act, which section 4 of S. 901 would repeal. To the extent that the detailed disclosure requirements of ERISA will keep the trustees and administrators of employee trust funds honest in the first instance, the salutory effects of section 102 simply cannot be overemphasized.

Certainly, I have no doubt that it was not the intent of the sponsors of S. 901 to weaken ERISA in this fashion. It is quite true that section 4 of the bill would still give rulemaking authority to the Department of Labor to require whatever degree of disclosure as may be deemed to be necessary by the Secretary who, it may be argued, should be more expert in such matters than the Congress.

Unfortunately however, any student of government will readily attest that at best, no matter how well intended any federal bureaucracy may be it will ultimately come to be dominated by whatever interest group it has been given statutory authority to regulate, and at worst, the Department of Labor in particular has traditionally been a highly political Department of the executive branch which has catered to the very same union officials who also serve as trustees of their members' pension, health and welfare funds. Let me hasten to qualify this last remark by saying that the current Secretary, Ray Marshall, has distinguished himself thus far in his term of office as a strong and independent administrator and regulator under ERISA. However, we have absolutely no assurance that future Secretaries might not relax or undo entirely whatever reporting requirements Secretary Marshall might promulgate under section 4 of S. 901. The only way to insure that the disclosure requirements remain adequate to protect the interests of fund participants and beneficiaries is to prescribe by statute what those requirements shall be.

Incidentally, now is neither the time, nor the place, to demonstrate with a greater volume of evidence the wholly inadequate job the Department of Labor has done over the years in prescribing useful reporting and disclosure regulations under Title II of the Landrum-Griffin Act. 29 U.S.C. § 431 et seq. If your committees should be interested in delving into the Department's miserable track record in this very closely related area, we would be happy to provide you with a history and analysis.

We find section 4 of your proposed legislation dangerous for several additional reasons. In the first place, breaches of the ERISA fiduciary duty standard will still occur. It is unrealistic to assume that the Department of Labor or any other federal agency will be able to ascertain each and every such violation and hold those responsible for the violations accountable in a court of law. Recognizing this fact of life, the Congress conferred standing in ERISA upon the participants and beneficiaries of employee trust funds to maintain their own suits against those responsible for violating their trust. However, without complete disclosure, the participants and beneficiaries will never become alerted to such abuses of trust and would not, therefore, be able to pay their intended role, and they would be effectively prevented from enjoying their unquestionable common law right as beneficiaries to monitor the performance of their trustees and to hold them accountable for breaches of trust.

Finally, summary plan descriptions and modifications in plans are potentially critical items of information both to the participants and beneficiaries, and to Government personnel. However, under section 4 of S. 901, these items of information would no longer be available to the Secretary of Labor, journalists, researchers or law enforcement personnel, and they very well might not be available even to participants or beneficiaries. Participants, in particular, have an absolutely critical interest in becoming and staying apprised of their plan descriptions and any modifications which may be made to them. Their employment decisions may be made based in substantial part upon benefits which accompany one job versus another. Plan modifications may even cause them to shift employment. They have a right to know exactly what their benefits are, or will be, at all times even if it should cause them to leave their jobs. Workers are not, after all, indentured servants of their employers and they should be free to shop for the best deal.

Similarly, those interested in, or responsible for, the enforcement of the laws and regulations covering employee trust funds would be deprived of an important tool if the administrators of plans were not required to provide the Secretary with summary plan descriptions and modifications. Assuming that the administrator must already provide thousands of participants and beneficiaries with this information, it is hardly an additional burden to ask them to drop one additional copy in the mail addressed to the Secretary. And, with this information, the Secretary might discover inconsistencies between the actual trust instrument and the summary plan description which could mislead participants and beneficiaries. Whether or not the discrepancies may have been deliberate, once again if the administrators of employee trust funds know that knowledgeable experts may also be looking at their representations, in addition to employees who cannot be expected to understand the intricacies of complex trust funds, they may be more careful in preparing their representations so as to communicate only accurate facts and impressions. Participants and beneficiaries deserve no less.

In summary therefore, we would have to say that we find section 4 of S. 901 totally unacceptable. We consider the benefits of the detailed disclosure requirements of ERISA to outweigh the costs from the point of view of the participants and beneficiaries whose interests are paramount. While we would be willing to consider some possible fine tuning of these requirements, we would have to oppose the wholesale repeal of the ERISA reporting and disclosure provisions.

Sections 2 and 3: The problem of overlapping or divided responsibilities

There can be no doubt that Congress' original decision reflected in ERISA to divide responsibilities for implementing and enforcing that Act among various departments and agencies of the federal government was not the most sensible decision which could have been made. While I have never headed an agency, my experience in working within an agency and more recently in monitoring various agencies and departments in the federal bureaucracy has taught me that whenever there is overlapping jurisdiction between different agencies or departments, very little is accomplished and that which is accomplished is often inconsistent if not downright contradictory. Thus we strongly support in principle your objective of trying to eliminate overlapping jurisdiction among the agencies responsible for implementation and enforcement of ERISA.

However, while these problems may significantly abate in the event S. 901 should be enacted, they will by no means disappear. Moreover, a new set of problems may arise. Just because the Congress originally assigned overlapping jurisdiction to the IRS and the Department of Labor is not, in our view, sufficient reason now to clearly divide their respective responsibilities under ERISA simply along the lines where they have been principally active since enactment. Rather, we believe that the only sensible solution is to assign full responsibility to a single agency or department, whether it be a new agency or an existing agency or department.

The advantages of a single agency are fairly obvious. First, no matter how clearly one attempts to delineate responsibility between agencies, the two agencies must still coordinate their efforts. Coordination between agencies is difficult at best. Lines of communication must be established which already exist within every agency. Agencies are inevitably jealous of one another's authorities and don't customarily communicate or collaborate very well among themselves. Moreover, every agency feels that it is underfinanced and understaffed and where responsibility for implementation or enforcement of a law is divided, each will frequently try and limit its own expenditures and shift responsibility to the other. A classic example was the recent episode involving the Teamster Central States Pension Fund where the IRS simply revoked the tax exempt status of the Fund midstream in the Department of Labor's investigation of the Fund's compliance with the ERISA fiduciary duty requirements. As I understand the proposed legislation, this type of incident could still occur.

Addressing the specific allocation of responsibility proposed in S. 901, I do not see how the Department of Labor can successfully handle enforcement of the fiduciary standard and prohibited transaction provisions of ERISA without total familiarity with the participation, vesting and funding regulations and their objectives. Even assuming that Labor personnel could acquire such familiarity through tutoring by IRS personnel, should they tend to disagree with the IRS regulations, they might simply decide not to enforce them. And, even if they agreed, no agency likes to feel that it is simply doing all the hard, dirty work on behalf of another agency.

Incidentally, I note that section 6 of S. 901 proposes the addition of a new paragraph (c) to section 3004 of ERISA which would require the Secretary of the Treasury to notify Labor and Justice only in the event he has in fact discovered a violation of fiduciary duty yet imposes no duty upon either of those Departments to take remedial action. This provision will inevitably create tensions within the executive branch. And, even if the provision is to remain, at the very least the Secretary of the Treasury should be instructed to call attention to breaches of fiduciary standards which he has reason to believe "may have occurred", rather than only to those he in fact knows to have occurred as required the present wording.

We also question the wisdom of delegating responsibility for enforcing just the fiduciary standards to the Department of Labor. Should the Department be shorn of broader authority under ERISA, it may well grow to feel less responsible for enforcing the Act and yield to its natural alliances with officers of organized labor who are the very individuals, among others, that it would have to prosecute if it were to zealously enforce the Act.

In summation, we believe that responsibility for implementing and enforcing ERISA should be assigned to a single agency which is capable of guaranteeing that Congressional objectives will be achieved and protected. Whether that agency should be the Department of Labor, IRS, Justice, SEC or some totally new unit is a question which might best be left to the President to answer in conjunction with his efforts to reorganize and streamline the executive branch. Clearly, it should be whatever agency that has the greatest level of competence in the type of skills necessary to do the job and which is now, and is likely to remain, committed to doing the job.

Section 7 procedures

We, too, lament the inordinate delays which have faced the administrators of funds seeking variances and exemptions. Assuming all applications are meritorious and that they are in the best interests of the covered participants and beneficiaries, long delays occasioned by the Government are inexcusable. Unfortunately, however, this may not be a safe assumption. To the contrary, it is entirely possible, if not likely, that a number of the variances or exemptions sought might have a deliterious impact on the integrity of the fund or that they might not best promote the objectives of the Act and protect the interests of participants and beneficiaries. And, if those seeking the exemptions or variances could drag the Government into court to oppose their applications for declaratory judgment that they are entitled to their exemptions or variances, it is entirely likely that they would be able to hamstring the government and the effective enforcement of ERISA.

We would be more than eager to consider another method for pressuring the government to expedite its processing of these applications. We suspect that part of the reason for the current backlog is that Government personnel are devoting much of their time to finalizing the regulations under ERISA. Once this task has been completed, these experts will be able to devote their full attention to other matters including the processing of such applications. Moreover, it is also likely that the volume of applications will never again be as high as it has been owing to the fact that every employee trust plan found itself rather suddenly having to try and bring themselves into compliance with a very complicated law. Once the necessary adjustments have been made, the rate at which the applications for exemptions and variances have been arriving in Washington may very well drop off dramatically.

In the meantime, however, if administrators could win their applications which should never be granted only because the government lacks the resources to accommodate the unusual crunch of filings, the policies underlying ERISA may be frustrated and many participants and beneficiaries may suffer. Thus, we do not favor the particular procedures set forth in section 7 as the means for expediting government processing of these applications.

S. 285

I would like now to briefly focus upon the proposed Tax-Exempt Private Pension Investment Act. We strongly support the goals and the means of attaining them set forth in section 2 of this bill. We agree with all the reasons that have been reciated in support of this provision to limit the degree of control of pension fund managers in large corporations. Indeed, we suspect that one reason why there has been such investor uncertainty and reluctance on the part of small investors to get back into the stock market in the wake of the recession of the early 1970's is due in part to the crazy fluctuations in price of many issues brought on by the purchase or sale of huge blocks of stock by pension managers who have such vast quantities of capital at their disposal to invest. We also believe that corporations should be run by those who are most familiar with their particular lines of business and that they should not be subject to undue influence by large financial institutions to make decisions based upon their immediate interests in high dividends or rapid stock appreciation. If pension managers can develop this kind of clout through purchases of major portions of the outstanding stock of corporations, we will be embarking upon an era where the soundness of our economy may be in jeopardy.

There is another reason why pension managers should be limited to a relatively minor percent of ownership of corporations. Money, whether it is your own or just the money you have to invest, can buy political influence. We have in this country a crazy quilt of interwoven business relationships. We also have in this country a not unsubstantial number of businessmen and even pension fund managers who may wish to wield political power to accomplish some illegitimate, corrupt or even criminal purposes. Time and again, honest hard working members of the Teamsters Union who have sought to enlist the sympathy, aid or support of members of the business and political communities have been met by a chilly silence if not baffling resistance. The only possible explanation for this phenomenon is that their support has been bought by those Teamster officials who have had the ability to purchase their "understanding" if not friendship when investing the billions of dollars which reside in their many Taft-Hartley trust funds.

By the same token, for all these and many more reasons, we question whether pension managers should be restrained from dominating only those corporations valued at $150 million, or more. We also question why the restriction should apply only to those managers whose funds aggregate $1 billion, or more. We would suggest that these limits be reconsidered and lowered significantly. We would also suggest that further criteria be established so that the managers of funds wishing to invest in a corporation whose net worth is $100 below the designated level not be allowed to purchase a controlling interest in that corporation. If the basic concept of preventing pension fund managers from dominating corporations and causing their stocks to be subjected to wild fluctuations in value has merit, and it surely does, then why should it be applied so arbitrarily just to certain corporations and funds? And what is to prevent the managers of smaller funds from collaborating among one another to accomplish the same ends which this bill is designed to prevent? We strongly support section 2 of S. 285 only insofar as it goes.

We also support the goals which section 3 is designed to promote but we must question the wisdom of a blanket repeal of the ERISA fiduciary duty standard with regard to any portion of the assets of a pension fund. Something less severe, yet still designed to give the managers of pension funds somewhat greater latitude with regard to investments in business "ventures" might be considered. We simply do not believe that the managers of pension funds ought to be able to treat even a small percent of their funds' assets as "mad money". By the same token, I cannot imagine that the existing ERISA fiduciary duty standard would ever be construed as a total prohibition on the investment of a relatively minor portion of a funds' assets in a well-researched and solid, albeit small and more venturesome corporation.

Incidentally, I would call your attention to the fact that while I understand your intention in section 3 is to permit the investment of no greater than 2 percent of a funds' assets, it may be possible to construe the section to prohibit only the investment of 2 percent of the fund's assets in any single corporation which is more highly venturesome. This ambiguity could be cured by making plural the singular word "corporation" in line 3 on page 6.

Senator BENTSEN. This will conclude our hearings until June. Thank you very much.

[Thereupon, at 11:35 p.m., the hearings in the above-entitled matter were recessed, to reconvene at the call of the Chair.]

PENSION SIMPLIFICATION AND INVESMENT RULES

TUESDAY, JUNE 28, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS OF THE COMMITTEE ON
FINANCE, AND THE SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senator Bentsen.

Senator BENTSEN. These hearings will come to order.

Our first witnesses will be Prof. Roy Schotland, Georgetown University Law School and Harrison V. Smith, executive vice president of the Morgan Guaranty Trust Co.

Gentlemen please come forward and take a seat at the table. This morning we continue joint hearings of the Senate Finance Committee's Private Pension Plans Subcommittee and the Senate Small Business Committee. Our previous hearings clearly demonstrated that overlapping jurisdiction in the administration of ERISA by the Treasury and the Labor Departments has created a bureaucratic nightmare resulting in excessive regulatory delays, duplicate reporting requirements and inconsistent agency rulings.

This morning, while I was dressing to come here, I listened to the radio and heard an advertisement, saying if you are dropping your pension plan, if you are closing out your pension plans, then these are some of the things that you can do. We have seen thousands of small pension plans that have been closed out representing thousands and thousands of employees, particularly the smaller companies.

Much of the fault is some of the over-regulation that has resulted from ERISA—something that has to be addressed, and addressed soon. Legislation is needed to remedy this problem, to prevent some of these plans from really being strangled by Government paperwork and redtape.

I strongly believe that the only realistic approach to effectively streamline the implementation of ERISA is to carefully divide the pension jurisdiction between the Departments of Labor and Treasury. Failure of the Congress to act would constitute a loss of workers and senior citizens throughout the Nation.

Our previous hearings also demonstrated that the prudent man rule in ERISA has unintentionally discouraged investments in smaller and medium-sized companies. If pension investments continue to be artificially channelled to larger and well-established firms, we may see greater and greater concentration in our economy.

We must avoid governmental impediments to the growth of innovative firms if we are to maintain a healthy, competitive economy.

There seems to be an adverse trend in this country as far as equity financing of small companies. A lot of it, I think, has been caused by actions of the Congress and the executive branch with unintended results. You see it in competitive commissions on stock that resulted in a liquidation of the smaller brokerage firms around the country, the regional firms that took an interest in their local stocks and their local companies and maintained trading in that stock and helped in the floating of issues for new equity.

You have seen those brokerage firms become large national firms in general without interest in the local shares.

In turn, you are seeing, under the prudent man rule, those people who handle those portfolios are afraid to go into the smaller companies. If they make a mistake in an investment in General Motors, nobody is going to question it later. But if they make a mistake in investing in Widget Corp., that no one ever heard of and it finally goes down the tube, then they question them as to whether they were prudent in putting in pension fund money, and you put a serious limitation on venture capital in this country.

Today, private pension assets are managed by relatively small numbers of financial institutions. There have been instances in which these pension managers tended to concentrate their investments in stocks of the same few companies, and that creates a potentially dangerous investment situation for pension plan participants.

If one of these very small groups of pension managers decides to sell a major investment on a bit of news, and other managers attempt to follow, they find that that gate suddenly gets very narrow, and this situation can result in a very substantial reduction in the price of the stock to the detriment of countless thousands of American workers and retirees.

Greater safety of pension assets can be insured if pension investments are reasonably diversified and decisionmaking is spread over a larger number of advisors. This will help avoid tendencies toward a follow-the-leader syndrome. A multiplicity of investment decisions gives you a much truer market.

It will also help avoid precipitous fluctuations in stock prices and self-fulfilling prophecies.

A very substantial manager of a pension fund, makes an investment in stock and then he decides to continue to buy that stock, He is going to hold that price up. He can, in effect, rig the price of that stock. He can see that it has the support that makes him look good to the people that he reports to.

Under S. 285, a penalty would be imposed on large pension managers that hold more than 5 percent of the outstanding stock of a company. However, investments in smaller firms would be exempt.

This rule would simply insure that all pension managers follow the example that some of the best pension managers have voluntarily adopted. Reasonable stock market holding limitations have been in effect for decades for life insurance companies.

In fact the New York State life insurance law specifically prevents insurance companies from holding more than 5 percent of the outstanding stock of a company. All major insurance companies in this country substantially comply with this rule.

Furthermore, an executive of Citibank, one of the Nation's largest banks, stated, if we held more than 5 percent of a company's stock, we would be concerned that we would be locked in. That 5 percent is our working rule for good market liquidity. Unfortunately, that has not been the case for a number of other instances where banks have held a much larger percentage.

Our studies show that one bank's trust department had more than 14 percent of the outstanding shares of Walt Disney, almost 12 percent of Schlumberger and over 10 percent of Polaroid. The aggregate discretionary accounts of another large bank included more than 17 percent of one company, close to 17 percent of a second company, over 10 percent of a third.

I do not want to see the situation develop in this country that has developed in Germany where, in effect, the banks control the companies. I do not think that situation will develop in this country, but we have seen exceptions and situations and lack of judgment by some large bank portfolio managers in that regard.

I think that leads to serious abuse and is a danger to the pension holder.

We are fortunate to have several qualified witnesses to discuss these issues this morning, and I want to ask that each of these witnesses limit their prepared oral statement to 10 minutes in order to leave some time for questions and exchange of views; but each of them will be allowed to present their full prepared text for the record.

I would like to first welcome Prof. Roy Schotland of Georgetown University Law School, who is one of the Nation's leading academic authorities on pensions and Mr. Harrison V. Smith, of the Morgan Guaranty Trust Co.

Professor Schotland, if you would proceed with your testimony first.

STATEMENT OF PROF. ROY SCHOTLAND, GEORGETOWN UNIVERSITY LAW SCHOOL

Mr. SCHOTLAND. Thank you, Mr. Chairman.

Three years ago I was privileged, as today, to open your hearing on this important but simple bill, to make a modest but significant improvement on a financial problem which is complex, pervasively important, and steadily becoming worse. It is only an accident of history that our law: (1) Limits the amount of stock any single investment company or mutual fund can hold in any single company, a limit Congress imposed when it first "chartered" such funds in 1940; (2) limits, by State statutes, the amount of stock any single insurance company can hold in any single company, statutes going back decades to the period of first concern about the large size of what were our first "institutional investors"; but (3) places no limit whatsoever upon how much stock in any one company can be held by even the hugest investment manager of pension assets—unless, of course, the assets happen to be managed by an insurance company or are directly invested in an investment company.

This gap by historical accident matters—indeed, it is one of those gaps which exemplifies that old charge that "the law is an ass"—because it means that the biggest institutional investor accounts, the pension funds, which are mostly managed by the biggest institutional investors, the bank trust departments, can concentrate pension investments much more than can smaller institutions.

Before I briefly explain why Senator Bentsen's proposal for limiting the biggest managers of pension assets to 5-percent ceilings on their stockholding in any one company is both modest and sound, I wish to comment even more briefly on two other pending proposals.

First, Senator Bentsen's pension simplification bill, S. 901, would carefully and wisely improve the jurisdictional overlap in administration of ERISA between the Treasury and Labor Departments.

In my statement I spell out why 901 is the best answer to that problem. Certainly, the present situation must be improved before the typical rigor mortis of the Potomac sets in and improvement becomes impossible.

I also would like to comment very briefly on the modification of the prudent man rule, in which I am happy to see that the Morgan, as so many others, agree that improvement is needed.

No one is proposing to abandon the requirements of prudence for some portion of pension portfolios. Actually, the problem is by no means all the result of ERISA, though that great reform is a prime whipping boy these days, responsible for all ills except saccharin and the British economy. Two other causes have been at work.

Most importantly, high bond yields, and unusually high dividend yields from even major growth companies, have created a risk-reward spectrum which has crowded out smaller companies.

Second, one stupid dictum by the high court of New York in 1974 (*In re Bank of New York*, 35 N.Y. 2d 517, 364 N.Y.S. 2d 164) said that the test of prudence applies to every investment in isolation, regardless of its relative size and riskiness in light of the portfolio considered as a whole. That court did not act on its own foolish statement, but many lawyers who confuse woodenness with conservatism, and many pension trustees who confuse their own invulnerability with prudence, have avoided full portfolio diversification as if all companies outside the top 500 were lemons.

The only sure and swift solution is to amend Federal law to make clear that mere size or newness or quietness of trading do not, in themselves, render an investment imprudent; and that the prudence of every investment must be evaluated not only on its own, but also in light of the plan's other investments taken as a whole.

Morgan's language is excellent, but it does need to be expanded to include something to make clear that the entire portfolio could not consist, prudently of small, new, thinly traded securities, but rather once again, every investment must be evaluated, not only on its own, but in light of the portfolio as a whole.

As for the proposed 5-percent holding limit, there are only two arguments against the bill. For one, the 30 biggest banks, those managing over $1 billion in pension equities—particularly the big 7, 6 of which are in New York City, which alone manage two-fifths of all pension trust accounts—may not be able to continue growing unimpeded, but will likely have to share some growth with the 4,000 other trust departments and other investment managers around the Nation.

Since almost none of those mammoth banks has produced good investment performance, the only loss if the bill passes will be to this clutch of giants themselves.

The only other argument opposing this bill is the general cry, "No new law." That view is misplaced here because this proposal will preserve free, efficient market operations, not interfere with them. This proposal is utterly simple and self-administering. Anyone who would oppose this bill—unless he thinks our 30 biggest banks and 12 biggest insurance companies need to continue utterly unrestrained expansion regardless of that expansion's impact on others—would also oppose first-time requirement of traffic lights, since they too interfere with unrestrained individual choice, and since we might try to rely on people to learn, after a few accidents, orderly driving.

This bill would reduce the risks in conflicts, it would protect the independence of portfolio companies, it would increase equity for smaller stockholders. I will not reiterate, but rather refer to, the 1974 hearing.

Primary is the interest of pension beneficiaries. ERISA calls for diversification, thanks to Senator Bentsen. But that wise requirement applies only to each plan. A plan's own assets may be well diversified but in fact, the plan may be unable to enjoy the protection of that diversification if the plan's investment manager is not also reasonably diversified as to the total of its pension assets.

Thus, ERISA's diversification provision is unfulfilled until S. 285 passes. An investment manager who runs many plans—indeed, the biggest manager, the Morgan, runs over $15 billion of pension assets—may have only reasonable amounts of, say IBM or Goodyear in each plan, but each such amount is likely to be large enough, and the number and size of the plans under management big enough, so that, again using the biggest example, the Morgan, one manager holds $1 billion in IBM stock alone, just in its pension accounts, not counting the $570 million more IBM in its other accounts.

They hold also well over 5 percent of the outstanding shares—well, in my prepared statement you see the list of what would hardly be called small companies, where their holdings are over 5 percent, just in pension accounts. I am not counting the rest of the trust department, nor am I counting any companies smaller than these giants.

How is the pension plan's ERISA-required diversification jeopardized if the investment manager holds, as the Morgan does, $1,569,800,000 of IBM (end-1976), almost three-fifths of that in pension accounts?

Well, if investment discretion decides IBM is a "sell"—and we are talking about 1975 and 1976, not the 1977 $280 tender offer by IBM itself—then we find the Morgan making net sales of IBM of $96.4 million in 1976 alone. To do that, they were selling IBM on 249 days.

Now the market was open at most 253 days last year, so after those open but dead days like the Jewish High Holidays and the annual picnic of stock traders, we find the Morgan "hitting the bid" in IBM every day. In 1975, they made another $90 million in net sales of IBM, selling on all but 12 days the market was open.

Whether or not such concentrated selling from one source affects the price—and in the phenomenally big IMB, it might very well not—it obviously is an unbelievably slow process, which costs pension accounts the very protection of diversification that ERISA aims at.

Indeed, the more responsible the investment manager—and the Morgan is truly exemplary—the slower will be the market moves, so as not to distort the market prices. And in fact, while I want to emphasize not only my respect for the Morgan but my informed belief that they are as responsible, if not the very most responsible big institutional investor of all, the fact is that their invesment performance has been unimpressive despite their great competence and resources.

I have analyzed just how large a share of the trading the Morgan accounts for in each of only the big stocks—mostly companies worth $200 million or more, some worth between $100 and 200 million, and all NYSE-listed—in which it does major buying or selling. I did this for 1973–75 for publication in a study by the House Banking Committee, which, with your permission, I would like to incorporate into the record of this hearing as an appendix to my statement (app. 2).

That study, also limited to trading solely within the Morgan's investment discretion, showed the Morgan in 1975 doing 38.5 percent of all buying in Kaiser Aluminum; 31 percent of all buying in International Nickel, and in 1974, another 25 percent of the buying in Nickel; 24 percent of the buying in another New York bank, Manufacturers Hanover; and in short, over the 3 years there were 16 stocks in which the Morgan alone bought or sold over 20 percent of all trading during a year, and 128 instances in which they did over 5 percent.

For this hearing, and once again with the continuing generous cooperation from the Morgan itself, I analyzed their 1976 trading and found another 74 instances of over-5-percent trading.

Let me comment here on the study of its own trading which the Morgan has brought here today. For 1976, they studied 94 stocks instead of 74. I hope the Chair will request that they come back with a redone study. They may come up with the same results. I am delighted that they went through the list to refine my own figures on their 1976 trading. For example, I was sorry to "lose" Deere—it went down from 42 percent of total volume to 7 or 8 percent. I appreciate their correcting that. But now I hope the Chair will ask them to correct their own studies of their price impacts, to use their own accurate data.

Of the 202 instances in these 4 years in which they accounted for more than 5 percent of annual volume, 128, or 63 percent, involved stocks in which they held over 5 percent of the outstanding shares.

I do not think the Senator has ever suggested that the 5-percent limit is a cure to all of these ills, let alone the rest of the world's problems. Obviously it is only a step toward greatly reducing its problems.

I speak only of the Morgan, not for any reason except their size. I have the tables in my prepared statement with data showing the extraordinary growth of pension equities.

In the past 5 years, pension equities have gone up over $8 billion a year, while all equities in the United States have gone down about $11 billion a year.

One could quickly extrapolate from that to see that the most concentrated pension managers—and they are even more concentrated in terms of pension accounts' equity holdings—have enormous market impacts. Indeed, in a study (app. 3) which I believe is unprecedented, we analyzed, for the purpose of this hearing, trading of 139 banks managing $2 billion in equities alone (not, I hasten to say, all pension assets; no such data are available) in the first quarter of 1977. The study is highly conservative, because Morgan is only one of two State member banks that have the respect for the public that they make their own figures available, even though they are not required to do it. Only the national banks are required to report, so we have Bankers Trust, U.S. Trust, Manufacturers Hanover and other majors listed in my statement giving us virtually no public information. So this is conservative data.

What did we find? We found, for example, that the banks did 73 percent of all buying in E. F. Macdonald, 46 percent of all the buying in Royal Dutch. The average share of total volume accounted for by their buying in the 88 stocks in which they were heaviest, was 30 percent. The average share of total volume for their selling in the 88 stocks in which they were heaviest was 17 percent. We analyzed 882 stocks through the auspices of one of the finest computer firms, and most savy with this data, in the Nation.

What happened to the prices on these stocks? This was a down quarter. The unweighted NYSE average, the average relevant for these purposes, was down 2.2 percent. The stocks in which the banks were the heaviest buyers were down only 0.2 percent. The stocks in which the banks were the biggest sellers were down 8.1 percent.

Did those prices move that way because the banks were smart, or lucky, or because they were just such a huge share of the market? We traced the price movements in April–May. We found total randomness. That is, the banks as a group were unable to enjoy the benefits of their own illiquid impacts on prices.

We did the same study on an earlier quarter, in an "up" quarter in 1976: the same results. We did the same study on mutual funds, which although smaller in total assets are much more active. We found the same results.

What does this say? This says that outside of a few dozen or perhaps a hundred or so of the various biggest stocks, the market is highly illiquid.

Let me hasten to emphasize that I am not for a moment suggesting that this was consciously parallel trading, although I cannot refrain from pointing out that I would like to study the role of correspondent banks (the Morgan, I believe, does no such work) or the kind of putting out of common research that the U.S. Trust does, and see what would follow from those flows. Nor am I saying the two quarters' data proves anything. Indeed, the first time I studied Morgan's share of the market in 1973, people who think the market can never work wrong said "it is only one year." I now have three more years; it comes out the same way, and even stronger.

The short of it is that this bill will make law of the practices which many banks already follow. What Mr. Theobald of Citibank said, before the chairman introduced this bill to take him seriously, is what all banks should be doing. We need more dispersion of pension managers. We need more diversification under common management.

Morgan says more dispersion among managers will not lead to more diversification of stock. They say they are more diverse—this is true—than anybody. It is not just a matter of how many stocks. It is also a matter of which stocks, and when they buy and when they sell, and at what prices.

Morgan's argument is like saying, if we enlarge the wardrobe of 1,000 ladies we would get less diversity of dress than if we enlarged the wardrobe of the best-dressed ladies, since the fact is that the best-dressed 7 have much more diverse wardrobes than the other 1,000.

Mr. Chairman, as I say, we have first-hand data here on price impacts. It is not conclusive, but it is, at very least, suggestive and interesting, and I hope we will have the opportunity to do more with such studies.

I request the chairman to allow me to supplement my statements with the computer reports (app. 3), as well as the earlier study I did of the Morgan's trading (app. 2) and the chair might also request Morgan to redo their study of their price impacts on the 74 stocks that in 1976, as they told me through their courtesy, were the right ones to look at, and not the 94 which they and I both started out with before the data were refined.

Thank you very much.

Senator BENTSEN. Thank you very much, Professor. We allowed you to go over your time somewhat because we thought your information goes to the heart of this situation, and we should have it in as much of its entirety as we could.

[The prepared statement of Mr. Schotland follows. Oral testimony continues on p. 246.]

TESTIMONY OF ROY A. SCHOTLAND, PROFESSOR, GEORGETOWN U. LAW SCHOOL

Three years ago I was privileged, as today, to open your Hearing on this important but simple bill, to make a modest but significant improvement on a financial problem which is complex, pervasively important, and steadily becoming worse.[1] It is only an accident of history that our law:

Limits the amount of stock any single investment company or mutual fund can hold in any single company, a limit Congress imposed when it first "chartered" such funds in 1940;

Limits, by State statutes, the amount of stock any single insurance company can hold in any single company, statutes going back decades to the period of first concern about the large size of what were our first "institutional investors"; and

Places no limit whatsoever upon how much stock in any one company can be held by even the hughest investment manager of pension assets (unless, of course, the assets happen to be managed by an insurance company or are directly invested in an investment company).

This gap by historical accident matters—indeed, it's one of those gaps which exemplifies that old charge that "the law is an ass"—because it means that the biggest institutional investor accounts, the pension funds, which are mostly managed by the biggest institutional investors, the bank trust departments, can con-

[1] See Hearings on Stockholders Investment Act of 1974, Subcommittee on Financial Markets, Senate Committee on Finance, 93d Cong. 2d Sess. (1974), pp. 56–91 et seq.

centrate pension investments much more than can smaller institutions. Can, and do, as I will show. These facts mean unnecessary risks are being taken by (1) pension beneficiaries and sponsors; (2) the corporations and other stockholders where the pension accounts are invested; and also very importantly, by (3) the stock markets and all other investors, individuals as well as other institutions.

Before I briefly explain why Senator Bentsen's proposal for limiting the biggest managers of pension assets to 5 percent ceilings on their stockholding in any one company is both modest and sound, I wish to comment even more briefly on two other pending proposals.

ADMINISTRATIVE JURISDICTION OVER ERISA

First, Senator Bentsen's pension simplification bill, S. 901, would carefully and wisely improve the jurisdictional overlap in administration of ERISA between the Treasury and Labor Departments. It makes no sense to have two Federal agencies administer the identical portions of ERISA. Dual jurisdiction has resulted in excessive regulatory delays, duplicate reporting requirements and inconsistent agency rulings. The real victims of this bureaucratic nightmare are pension plan participants. Every dollar spent by employers and pension plan managers fighting endless paperwork and red tape is a dollar that might otherwise be used better, some of it toward providing additional pension benefits. Although in theory it may sound appealing to establish a new pension agency, the fact is that the tax aspects of pensions make total severance from IRS unfeasible, a similar situation exists as to Labor, and so the Bentsen approach seems best. The present situation must be improved before it becomes so established as to defy improvement.

In response to questions at your May 10 pension hearing, both Assistant Secretary of the Treasury Laurence Woodworth and Assistant Secretary of Labor Francis Burkhardt endorsed the concept of carefully allocating pension jurisdiction between the Labor and Treasury Departments. I am pleased to join these Administration officials in support of this pension simplification proposal.

MAKING THE PRUDENT MAN RULE MORE PRUDENT

Modification of the prudent man rule, as proposed in S. 285 and S. 1745, is clearly an important need, though it is not as clear just how the modification would be best expressed. ERISA has been widely misconstrued to inhibit pension plan investment in corporations which are relatively small, or new, or less actively traded. Pension plans are by far the largest participants in equity markets, as I will particularize in a moment. These plans' constriction of all their investing only to large, established companies, instead of their recognizing that sound diversification of risks and rewards means modest investment in various kinds of companies, is a crisis and will become a disaster for the diversity of corporate America. What would be modest investment for huge pension plans, is a rich life-line for smaller companies.

No one is proposing to abandon the requirements of prudence for some portion of pension portfolios. I am pleased to learn that Senator Bentsen is likely to drop that portion of his proposal which would set a 2 percent level for smaller investments. Actually, this problem is by no means all the result of ERISA, though that great reform is a prime whipping-boy these days, responsible for all ills except saccarine and the British economy. Two other causes have been at work. Most importantly, high bond yields, and unusually high dividend yields from even major growth companies, have created a risk-reward spectrum which has crowded out smaller companies. Second, one stupid dictum by the high court of New York in 1974 (*In re Bank of New York*, 35 N.Y. 2d 517, 364 N.Y.S. 2d 164) said that the test of prudence applies to every investment in isolation, regardless of its relative size and riskiness in light of the portfolio considered as a whole. That court didn't act on its own foolish statement, but many lawyers who confuse woodenness with conservatism, and many pension trustees who confuse their own invulnerability with prudence, have avoided full portfolio diversication as if all companies outside the top 500 were lemons. Contrary to current lore, while big institutions have been somewhat increasing their diversification recently, bank holdings of the Famous Favorites have *risen*, not declined. To show this, I insert into the record of this hearing a June 13 Wall Street Journal article by Charles Ella (Appendix 1).

The only sure and swift solution is to amend Federal law to make clear that mere size or newness or quietness of trading do not, in themselves, render an investment imprudent; and that the prudence of every investment must be evaluated not only on its own, but also in light of the plan's other investments taken as a whole.

S. 285'S 5 PERCENT HOLDING LIMIT

Three years ago, a few weeks after Senator Bentsen's first hearing on his proposal to put some reasonable ceiling on the stockholding in any one large company (smaller companies cannot be treated the same, or they would simply be beyond the reach of large investment managers (which may be held by any one massive manager of pension funds. I had the privilege of spending an afternoon with Carter Golembe's "Trust Seminar", the heads of a dozen of America's biggest trust departments. We discussed conflicts of interests in trust departments, but at the end of one discussion, one of the trust chiefs asked why I had testified for the Bentsen bill, what was I worried about, was it conflicts of interests?

There are a number of reasons supporting the Bentsen bill, and surprisingly little to be said against it, apart from the usual boiler-plate rhetoric trotted out whenever a Member of Congress wants to deal with a problem before it becomes a crisis. Against this bill are only two arguments: For one, the 30 biggest banks, and particularly the big 7—six of which are in New York City—which alone manage two-fifths of all pension trust accounts, may not be able to continue growing unimpeded, but will likely have to share some growth with the 4,000 other trust departments and other investment managers around the nation. Since almost none of those mammoth banks has produced good investment performance, the only loss if the bill passes will be to this clutch of giants themselves. The only other argument is the general cry, "No new law". That view is misplaced here because this proposal will preserve free, efficient market operations, not interfere with them. This proposal is utterly simple and self-administering. Anyone who would oppose this bill—unless he thinks our 30 biggest banks and 12 biggest insurance companies used to continue utterly unrestricted expansion regardless of that expansion's impact on others--would also oppose first-time requirement of traffic lights, since they too interfere with unrestrained individual choice, and since we might try to rely on people to learn, after a few accidents, orderly driving.

This bill would reduce the risks in conflicts, it would protect the independence of portfolio companies, it would increase equity for smaller stockholders. I will not reiterate, but rather refer to, the 1974 Hearing.

Primary is the interest of pension beneficiaries. ERISA calls for diversification, thanks to Senator Bentsen. But that wise requirement applies only to each plan. A plan's own assets may be well diversified but in fact the plan may be unable to enjoy the protection of that diversification if the plan's investment manager is not also reasonably diversified as to the total of its pension assets. Thus, ERISA's diversification provision is unfulfilled until S. 285 passes. An investment manager who runs many plans—indeed, the biggest manager, the Morgan runs over $15 billion of pension assets—may have only reasonable amounts of, say, IBM or Goodyear in each plan, but each such amount is likely to be large enough, and the number and size of the plans under management big enough so that, again using the biggest example, the Morgan, one manager holds $1 billion in IBM stock alone, or well over 5% of the outstanding shares in:

> Goodyear, International Paper, Pepsico, Armstrong Cork, Burlington Industries, Champion International, Connecticut General Insurance, Crown Zellerback, Heublein, Louisiana Land, Melville, Pittston, Southern Railway, Squibb, Sterling Drug, and UAL.

Plus dozens more such unduly large holdings, all of this counting only the pension accounts' holdings exceeding 5 percent, and only, as the Morgan says, "holdings over which we have investment discretion." Thus I'm not even counting any piece of the additional $8 billion—just in equities—which Morgan manages for its personal trust and investment advisory accounts, also under their own investment discretion.

How is a pension plan's ERISA-required diversification jeopardized if the investment manager holds, as the Morgan does, $1,569,800,000 of IBM (end-1976), almost 3/5 of that in pension accounts? Well, if investment discretion decides IBM is a "sell"—and we're talking about 1975 and 1976, not the 1977 $280 tender offer by IBM itself—then we find the Morgan making net sales of IBM of $96.4 million in 1976 alone. To do that, they were selling IBM on 249 days. Now the market was open at most 253 days last year, so after those open but dead days like the Jewish High Holidays and the annual picnic of stock traders, we find the Morgan "hitting the bid" in IBM every day. In 1975, they made another $90 million in net sales of IBM, selling on all but 12 days the market was open. Whether or not such concentrated selling from one source affects the price—and in the phenomenally big IBM, it might not—it obviously is an unbelieveably slow process, which costs pension accounts the very protection of diviersification that ERISA aims at. Indeed, the more responsible the investment manager—and the Morgan is truly exemplary—the slower will be the market moves, so as not to distort the market prices. And in fast, while I want to emphasize not only my respect for the Morgan but my informed belief that they are responsible, if not the very most responsible big institutional investor of all, the fact is that their investment performance has been unimpressive despite their great competence and resources.

I have analyzed just how large a share of trading the Morgan accounts for in each or only the big stocks—mostly companies worth $200 million or more, some worth between $100 and $200 million, and all NYSE-listed—in which it does major buying or selling. I did this for 1973–4–5 for publication in a study by the House Banking Committee, which with your permission I would like to incorporate into the record of this Hearing as an appendix to my statement (Appendix 2). ~~That~~ study, also limited to trading solely within the Morgan's investment discretion, showed the Morgan in 1975 doing 38.5 percent of all buying in Kaiser Aluminum; 31 pe.cent of all buying in International Nickel, and in 1974 another 25 percent of the buying in Nickel; 24 percent of the buying in another New York bank, Manufacturers Hanover; and in short, over the three years there were 16 stocks in which the Morgan alone bought or sold over 20 percent of all trading during a year, and 128 instances in which they did over 5 percent.

For this Hearing, and once again with the continuing generous cooperation from the Morgan itself, I analyzed their 1976 trading and found another 74 instances of over-5 percent trading. These incuded 38 percent of all 1976 buying in Cincinnati Milacron, 33 percent of all selling in Dillon, 16 percent of all buying in another New York bank, Chemical, etc.

It has not been possible, because of limits on publicly available data, for anyone outside the Morgan to evaluate what if any price impacts their trading has had, but I submit without hesitation that massive holdings are bound to lead to massive trading, illiquid for pension beneficiaries and potentially price-distorting for the markets.

Of the 202 instances between 1973–76 in which the Morgan alone accounted for more than 5 percent of annual volume, 128 (or 63 percent) involved stocks in which the Morgan held over 5 percent of the outstanding shares. A 5-percent limit will obviously greatly reduce the incidence of concentrated trading.

Why do I speak only of the Morgan? Because their equity holdings are vastly bigger than any other manager. They alone manage over $19 billion of equities, almost $12 billion of that for pensions. The entire insurance industry put together, not merely one company, manages . . . $19 billion of pensions' equities.

Moreover, Morgan is merely the big tip of a concentrated iceberg. Although there are over 4,000 trust departments in America, 7 of them—six of the seven are in New York (Morgan, Citibank, Bankers Trust, Chase, U.S. Trust and Manufacturers Hanover—plus Pittsburgh's Mellon, in 5th place)—manage $63 billion or 38 percent of all bank-managed pension assets. This is over 17 percent of all pension assets [2] in America, in the hands of seven banks.

What is to be done to help protect pension beneficiaries from illiquidity, which undermines ERISA's diversification requirement? Simply treat the largest pension managers as we have long treated mutual funds and insurance companies: impose a ceiling on the holdings in any one stock. Indeed, many trustmen recog-

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[2] Excluding only Federal plans, like OASDI.

nize the need for such discipline. For example, one of the top Citibank executives, Mr. Theobald, said in 1972: "If we held more than 5 percent of a company's stock, we'd be concerned that we could become locked in. That 5 percent limit is our working rule for good market liquidity."

Three last points. First, why should anyone oppose this modest proposal? One very simple reason: while no manager would be forced to divest any holdings, lest the market be disrupted, the biggest managers which are already at or near the 5 percent limit would find it more difficult to attract new accounts. After all, pension trustees will say, "Why go to those biggest 30 banks who can't even put any of XYZ company in our portfolio, let's go to an equally well-performing bank which is smaller"—and here, "smaller" means (a) 41 bank trust departments with over $1 billion under management, let alone (b) the other 4,000 trust departments, (c) all but the 12 hugest insurance companies, and (d) all but the 6 or 7 biggest investment counsellors, etc.

So we will see a greaer dispersion of big asset managers, and a greater dispersion of portfolios within each manager. How can anyone oppose this, unless he wants to keep the giants growing without limit, or unless he opposes new law even when it is aimed at improving market functioning?

The London Economist, in giving two pages to my study of the Morgan, headlined the story, "In whom do we trust?" I have unlimited faith in the integrity and competence of the Morgan, but I have trust only in a free and open market with diverse participants. Only last week I received a press clipping about my Morgan study from Tobacco International, a trade publication I'm not familiar with. Their headline was "Another Seven Sisters." I believe our market system works best when it enjoys vigorous competition by diverse, reasonably-sized participants.

Your Committee, with Senator Williams' and Javits' Committee, led the Congress in shaping and passing ERISA, which whatever its problem was a great step forward. Your Committee, much earlier, essentially created pension funds. Pension assets are steadily rising, and ERISA's funding and vesting provisions are causing still further rises. The next page (Table 1) shows just how incredible is the rise in pension holdings of equities. In the last five years, such holdings rose at over $8 billion a year, while total equities in the U.S. dropped at over $11 billion a year. Ten years ago pension equities were two thirds of personal trusts; and only a little more than investment companies'; today, pensions' equities are two thirds larger than personal trusts', and a little more than three times as large as investment companies'. The subsequent page (Table 2) shows that about 72 percent of pension equities is managed by bank trust departments, and though precise figures are not available, about three fourths of the bank-managed pension equities are at only the 30 biggest banks.

TABLE 1.—THE SHARP RISE OF PENSION HOLIDAYS OF EQUITIES [1]

[In billions of dollars]

	1966	1971	1975	1976
1. Pensions:				
(a) Private noninsured	39.5	88.7	88.6	109.7
(b) Private insured	2.2	11.2	15.5	19.0
(c) State and local	2.8	15.4	24.3	30.1
Pension total (non-Federal)	44.5	115.3	128.4	158.8
2. Foundations and endowments	24.9	34.0	31.5	37.5
3. Personal trust accounts (banks)	66.7	94.1	81.0	96.1
4. Investment companies	37.0	59.5	44.0	48.9
Grand total, all institutions (not merely above-listed)	193.5	333.0	313.4	375.4
Grand total, all U.S. equities	650.7	1,003.7	756.7	945.4

[1] SEC reports as of each year's end; except for private insured pension funds, which is a close approximation derived from data of SEC and American Council of Life Insurance (see Life Insurance Fact Book, 1976, pp. 71, 85) with aid of latter's staff.

TABLE 2.—BANKS AND PENSION ASSETS AND EQUITIES

[In billions of dollars]

	1966	1971	1975	1976
1. Total trust assets	(1)	$343	$325	(2)
(a) Number of banks	(1)	3,624	4,049	(2)
(b) Number of banks managing $1,000,000,000 or more in pension assets [3]	(1)	21	30	(2)
(c) Portion of total trust assets those top banks manage (percent)	(1)	47	52	(2)
2. Total trust pension assets	(1)	$123.7	$165	(2)
(a) Portion of all major pension assets managed by banks (percent) [4]	(1)	57	51	(2)
(b) Trust pension assets managed by top banks	(1)	$86.3	$116	(2)
(c) Trust pension assets managed by top banks, as portion of total trust pension assets (percent)	(1)	70	70	(2)
3. Total trust pension equities	(1)	$83.7	$92.4	(2)
(a) Portion of all pension equities (percent) [5]	(1)	72	72	(2)
(b) Trust pension equities managed by Morgan alone (almost no others disclose this)	(1)	....	$9.9	11.5
(c) Portion of trust pension equities managed by Morgan alone (percent)	(1)	....	11	(2)

[1] Not available.
[2] Not available yet.
[3] Hereafter, "top banks."
[4] Excludes only Federal Government pension programs; e.g., OASDI. Source for total assets of major pension programs: Pension Facts 1976 (American Council of Life Insurance), p. 21.
[5] See table 1.

Having wisely, rightly created pensions and having wisely, rightly required their sound funding, you must take the fortunately modest step in S. 285 to prevent further concentration and illiquidity, injuring pension beneficiaries and all other market participants.

Let me show how illiquid our stock markets are, how badly we need to take at least modest and easy steps, while considering whether more should be done to restore an efficient market which will deserve public confidence.

In a study (appendix 3) which I believe is unprecedented,[3] we analyzed the trading of the 139 banks which manage $123 billion in equities alone (not all pension assets), in the first quarter of 1977, when they were active in 882 NYSE and ASE stocks.

The study is highly conservative, since it necessarily seriously understates the amount of bank trading, missing the activity of 38 percent of the biggest banks' assets, as well as many smaller banks.[4]

With the aid of an outstanding computer firm, we ranked the 882 stocks in 10 groups of 88 each, starting with those in which the banks were the biggest net buyers relative to total volume in those stocks, and going to stocks in which banks were biggest net sellers relative to total volume. For example, those banks did 73 percent of all buying in E.F. MacDonald, 56 percent and 55 percent in Bliss & Laughlin and Warner & Swasey, or to note a giant company, the banks did 46 percent of all the buying in Royal Dutch. The banks' average share of the buying in these 88 stocks was 30 percent. In the 88 stocks in which the banks did the biggest share of all selling, they averaged 17 percent of all selling.

Now, how did such concentrated bank activity affect the prices of those stocks? This was a "down" quarter, with the relevant index for these purposes, the unweighted NYSE average, down 2.2 percent. The stocks in which the banks were the heaviest buyers were down only 0.2 percent. The stocks in which the

[3] I am familiar with the SEC's Institutional Investor Study, having served for a year as its chief counsel. Its effort to conduct a study similar to this one involved conceptual barriers whose analysis is not difficult, but does go beyond the limits of this forum. Such analysis would put aside its findings.

[4] Public data are available only on national banks' trust departments and the one or two state-chartered banks which report voluntarily, as the Morgan does. Thus not included in these data are the following major trust departments (and their trust size rank): Bankers Trust (3), U.S. Trust (6), Manufacturers Hanover (7), Chemical Bank (13), Northern Trust (15), Wilmington Trust (16), Cleveland Trust (17), Bank of New York (18), Girard Trust (19), Irving Trust (23) and United California (26). The trust assets of those non-disclosing banks total $76 billion; the trust assets of the disclosing banks among the biggest 26, total $128 billion.

These banks' data are unavailable because the Federal Reserve Board has never seen fit to secure for the public the same information the Comptroller of the Currency has secured since end-1974. Soon SEC disclosure requirements will end this anomaly.

banks were the biggest sellers were down 8.1 percent. That pattern held up throughout the other 8 groups of 88 stocks each. To make sure the differences did not derive from sampling error, the analysis of "variance F-test" (which I personally do not pretend to understand) was "3.45, indicating greater than 99 percent confidence in the results."

Why did prices respond so to the heavy bank buying and selling?[5] Maybe the stock selection was smart (or lucky), maybe prices were merely responding to the size of the bank activity.

To see which, we traced the prices of these same stocks for April and May 1977. Since some of the buying and selling programs may have been continuing, and since so many sophisticated professional judgments were in agreement, the concentrated buys should have risen in April and May, at least as a group, at least in comparison with the concentrated sells. It didn't happen; total randomness resulted. The only inference possible is that the banks, when their trading is concentrated, are so large a share of the market that their sheer size moves prices. This is consistent with the banks' generally weak investment performance over the long term; indeed, in some measure this firms up long-suspected explanations of weak bank performance. Note that this is not a price movement the banks themselves, as a group, can get the benefit of. Note also that I have discussed only one quarter; but we did the same analysis of the banks' trading (this time, in 770 stocks) in a modest "up" quarter, 1976's Second, which had an unweighted average rise of 0.3 percent. We found the same results: The banks' most concentrated buys (on average for those 77 stocks, the banks did 31 percent of all buying) were up during that quarter by 4.5 percent, their most concentrated sales (on average, 25 percent of all selling in that group of 77 stocks) were down 2.1 percent.

I am not saying this was consciously parallel trading (though it would be interesting to study the role of correspondent banks and other sharing of common research sources).

I am not saying two quarters' data proves anything.[6] But these data are not merely interesting, they are highly suggestive. Big institutional investors, as years of data have shown, are unable to outperform the market averages, and our new data suggest a good bit of why: their own size gives them a market power which causes them to distort prices against their own interests, as well as reducing market efficiency for everyone. Interestingly, the same analyses applied to mutual funds, although they have only ⅓ as much equity assets and are somewhat, but not adequately, under a 5 percent holding limit. Mutual funds are much more active traders, they may trade more in concert, and inevitably they are more active in smaller stocks. Analysis of their concentrated trading yielded similar results. Indeed, the funds' concentrated buys in the first quarter of 1977 subsequently (April-May) performed worse than their concentrated sells, which may occur because of the funds' peculiar needs to meet cash redemptions and, therefore, a propensity to sell stocks which already have gains. With the Chair's permission, I would like to include these computer analyses as an appendix to my statement.

In short, while our equity markets may be efficient in a few dozen or one hundred biggest stocks, they are inefficient and seem highly illiquid in most securities. Prices in most securities seem highly vulnerable to serious distortions if large institutional interest is present, and it is little wonder that the individual investor has not only fled from direct investment, but also has been steadily saying goodbye to mutual funds.

Essentially the problems of equity investment and equity markets will not turn happy until the bigger economic picture improves. But the excesses of institutional investor participation, and particularly the unlimited herd-of-dinosaur-like presence of the biggest and fastest growing sector, the pension plans, must be corrected at least so far as can be without imposing diseconomies or regulatory entanglements.

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[5] Actual bank activity would have been even higher, since state member banks are not required to report; see above.

[6] The first time I analyzed the Morgan's trading, the only data public was one year's, 1973, and some people who believe that no market can ever misfunction hastened to point out that one year proved nothing. Analysis of 1974–6 showed continuance, even strengthening of my original statements.

I cannot prove yet, but believe, that fuller examination of institutionally-dominated stocks and those with high institutional activity—examination which requires more resources than I have—will similarly be confirmatory.

The Bentsen bill merely makes law of the practice many banks already follow, and Citibank's Mr. Theobald shows all should follow. The bill merely makes law for the biggest pension managers like the laws which other managers are under already. The bill will not solve all problems, but it will definitely cause (1) a dispersion of pension assets among more managers, and (2) more diversification of assets under common management. This is the kind of step that helps assure that pension plan investments will enjoy the benefits of efficient markets instead of contributing to those markets' decline. This is the kind of step aimed at avoiding more intrusive and more costly regulations which are bound to come unless we preserve free, open, efficient capital markets, and public confidence in them.

TABLE 3(a).—MORGAN GUARANTY TRUST CO., 1976 TRADING DATA—41 NET PURCHASES OVER 5 PERCENT OF ALL VOLUME

Stock	Dec. 31, 1975 holdings as percent of outstanding shares	Dec. 31, 1976 holdings as percent of outstanding shares	1976 purchases	1976 net purchase	1976 total trading [1]	Net purchases (percent) [2]
Cincinnati Milacron		9.4	364,550	345,948	911,800	37.9
Continental Corp	1.23	5.2	1,002,234	971,877	5,896,100	16.4
Southern Railway Co	4.17	8.5	633,757	635,477	4,135,400	15.3
Pittson Co	1.42	7.98	2,465,811	2,429,922	16,699,500	14.5
American Standard, Inc	2.27	11.89	1,126,515	981,347	7,065,500	13.8
Chemical N.Y. Corp	.69	4.7	724,550	572,614	4,424,100	12.9
ARA Services, Inc	4.26	6.5	304,750	234,550	1,959,500	11.9
National Steel	.57	2.9	440,705	438,701	3,825,100	11.5
Allis-Chalmers Corp		9.3	1,026,460	989,360	9,999,700	9.9
Borg Warner		2.2	403,900	403,135	4,095,100	9.8
Royal Dutch Petroleum	.05	.84	1,050,630	1,045,285	10,732,220	9.8
Burlington Northern	.70	5.0	545,800	540,600	5,629,600	9.6
UAL, Inc	3.26	9.0	1,495,400	1,427,520	15,217,800	9.4
Textron, Inc	4.47	6.4	711,200	455,110	5,020,800	9.1
Deere & Co	1.69	5.2	2,273,740	2,202,940	24,257,800	9.0
Santa Fe Industries		3.2	832,190	809,159	9,415,400	8.6
Norfolk & Western	1.60	3.8	710,055	692,301	8,154,890	8.5
Airco, Inc	1.37	4.5	470,010	380,010	4,467,900	8.5
Tektronix, Inc	.46	2.8	208,240	207,240	2,517,800	8.3
R. J. Reynolds Industries	1.30	2.9	806,377	781,471	9,557,800	8.2
Allied Stores	5.10	7.9	395,810	303,480	3,891,200	7.2
Eaton Corp		1.5	258,050	257,750	3,247,300	7.9
Missouri Pacific		6.5	561,635	452,703	6,098,800	8.4
Colt Industries		4.76	306,865	306,065	4,150,100	7.4
Scott Paper	2.10	4.0	1,133,400	883,938	13,085,700	6.8
Firestone Tire & Rubber	.63	1.9	709,055	630,395	9,211,400	6.8
Reynolds Metals Co	2.19	5.69	628,135	602,619	8,830,100	6.8
Mead Corp	5.22	8.4	1,105,484	728,083	10,810,200	6.7
Inland Steel Co	2.65	4.48	386,135	358,465	5,345,000	6.7
ITT	1.58	3.61	2,001,445	1,901,271	29,145,800	6.5
Southern Pacific Co	.17	1.28	345,800	340,175	5,288,500	6.4
Shell		.52	367,826	338,516	5,536,900	6.1
Union Pacific	.56	1.85	293,205	290,304	5,007,000	5.8
Bethlehem Steel	1.32	3.12	879,040	828,440	14,487,300	5.7
General Electric	1.65	2.07	1,649,884	1,531,514	27,404,500	5.6
Aluminum Co. of America	5.36	7.19	698,785	621,035	11,264,100	5.5
Tenneco	.06	1.63	1,302,635	1,163,005	21,721,100	5.4
Boeing Co		3.98	861,775	797,125	14,859,200	5.4
PPG Industries		1.65	333,900	332,600	6,117,800	5.4
Smith Kline Corp	.21	2.47	257,345	243,975	4,605,000	5.3
Minnesota Mining and Manufacturing	1.43	2.19	1,175,670	925,527	18,449,500	5.0

[1] 1976 total trading of the stocks—New York Stock Exchange composite, including regionals and 3d markets.
[2] Net purchases by Morgan as a percent of New York Stock Exchange composite.

Sources. Col. 1—Report of the Trust and Investment Division, Morgan Guaranty Trust Co. of New York, 1975; cols 2-3—Report of the Trust and Investment Division, Morgan Guaranty Trust Co. of New York, 1976; col. 4—after deducting figures prepared for this table by Morgan staff; col. 5—volume data adjusted to reflect stock splits, prepared for this table by analystics and interactive data, under the auspices of the Morgan.

TABLE 3(b).—MORGAN GUARANTY TRUST CO. 1976 TRADING DATA—33 NET SALES OVER 5 PERCENT OF ALL VOLUME

Stock	Dec. 31, 1975 holdings as percent of outstanding shares	Dec. 31, 1976 holdings as percent of outstanding shares	1976 sales	1976 net sales	1976 total trading[1]	Net sales (percent)[2]
Dillon Cos., Inc	4.79	2.1	231,629	231,329	694,601	33.3
Genuine Parts Co	10.43	6.0	638,395		2,544,600	25.1
Echlin Manufacturing Co	9.68	1.7	489,953		2,047,800	23.9
Knight-Ridder Newspapers	2.68	.23	347,500	344,500	2,205,300	15.6
Richardson Merrill	7.21	4.39	530,916	528,916	3,572,600	14.8
Skaggs Co	8.4	3.7	323,800		2,566,600	12.6
Dun & Bradstreet	4.5	2.1	557,126		4,520,000	12.3
Gannett Co	2.57	.54	381,430	378,830	3,305,800	11.5
Emery Air Freight	4.03	1.13	241,325		2,091,800	11.5
Lubrozol Corp	6.26	3.2	692,340	524,640	4,578,300	11.4
Baker International		.66	490,247		4,331,200	11.3
National Chemsearch	12.35	8.56	437,081	427,081	3,783,000	11.2
Coca Cola Bottling Co.—New York	7.79	1.1	1,037,470		9,853,100	10.5
International Flavors & Fragrance	6.63	3.97	1,054,691	871,291	8,313,200	10.4
Marsh & McLennan	7.14	5 2	247,783	246,283	2,564,400	9.6
Envirotech	6.79	1.1	250,900		2,644,300	9.5
Consolidated Freightways	15.80	12.65	444,267	348,267	3,811,200	9.1
Lowes Co	9.92	7.6	325,656		3,910,600	8.3
Cummins Engines Co	73.4	4.1	268,650	214,950	2,604,500	8.2
AMP, Inc	7.12	4.9	774,757	660,907	8,647,300	7.6
American Home Products	5.67	4.3	1,976,676	1,914,801	25,651,400	7.5
Eckerd (Jack) Corp	2.55	.88	316,900		4,224,900	7.5
First International Bancshares	5.36	4.1	247,315	190,615	2,592,200	7.3
Burlington Industries	11.11	9.11	481,035	469,135	6,426,700	7.2
Chesebrough-Pond's Inc	10.3	7.0	559,678	399,878	5,717,490	6.9
Schlumberger Ltd	6.01	4.35	886,510	822,370	12,718,200	6.5
Gillette Co	8.12	5.78	653,097	610,597	10,445,600	5.8
Halliburton Co	5.27	3.5	992,636	884,936	16,255,500	5.4
McDonald's Corp	5.7	2.96	983,535		18,077,400	5.4
Hercules, Inc	2.36	.85	631,124	619,976	11,581,800	5.3
Disney Productions	8.64	5.33	872,287	869,785	16,450,700	5.2
Ralston Purina	4.64	3.62	316,359	271,659	5,416,300	5.0
Perkin-Elmer Corp	5.47	2.61	485,872	354,572	7,046,800	5.0

[1] 1976 trading of the stock—New York Stock Exchange Composite.

[2] Net sales by Morgan as a percent of New York Stock Exchange composite.

Source: Col. 1—Report of the Trust and Investment Division, Morgan Guaranty Trust Co. of New York, 1975; cols. 2-3—Report of the Trust and Investment Division, Morgan Guaranty Trust Co. of New York, 1976; col 4- after deducting figures prepared for this table by Morgan staff; col. 5—volume data adjusted to reflect stock splits, prepared for this table by analystics and interactive data, under the auspices of the Morgan.

TABLE 4.—MORGAN'S HOLDINGS OF 5 PERCENT OR MORE OF OUTSTANDING SHARES (OVER ALL OF WHICH MORGAN HAS INVESTMENT DISCRETION)

	1973	Holdings[1]	1974	Holdings[1]	1975	Holdings[1]	1976	Holdings
(a) Morgan holdings of 5 percent or more of companies with market value exceeding $200,000,000:								
5 or more	96	61	59	41	84	43	82	35
10 or more	42	11	23	2	23	4	15	3
15 or more	13	1	2		3		1	
20 or more	1							
25 or more	1							
(b) Morgan holdings of 5 percent or more of companies with market value under $200,000,000:								
5 or more	61	48	80	54	102	80	101	77
10 or more	17	12	25	14	27	12	19	9
15 or more	5	4	9	5	8	4	6	5
20 or more	3	2	3	2	4	2	2	2
25 or more	2	1	2	1	2	1	1	1
(c) Combined totals of items (a) and (b):								
5 or more	157	109	139	95	186	123	183	112
10 or more	59	23	48	16	50	16	34	12
15 or more	18	5	11	5	11	4	7	5
20 or more	4	2	3	2	4	2	2	2
25 or more	3	1	2	1	2	1	1	1

[1] Number of holdings in Morgan's employee benefit accounts alone.

Note: Figures are cumulative from bottom up. Thus in item (a), for 1973, there are 54 holdings of 5-10 percent, 29 of 10-15 percent, 12 of 15-20 percent, and 1 above 20 percent.

Appendix 1

[From the Wall Street Journal, June 13, 1977]

Bank Sector Owns More of Glamour Shares in 1977 Than It Did at End of 1974, Study Finds

(By Charles J. Elia)

Ask any 100 market players what the really big investors have been doing for the past two years and 99 are likely to say the institutions have been dumping their growth stocks to diversify their portfolios.

There's some truth to that, of course. Investment interest has broadened since 1974 to include a wider range of stocks than in the growth-stocks heyday of 1972–73. And the weight, or value, of the earlier market favorites has definitely been downgraded within many institutional portfolios.

But anyone who thinks this means that the biggest institutional sector—bank trust departments—has reduced its concentration of ownership of the old favorites has a surprise coming.

The bank sector as a whole—and that is where most pension funds are managed—today owns a larger percentage of the shares outstanding of Eastman Kodak, International Business Machines, Eli Lilly and a host of other shell-shocked glamour stocks than it did at the end of 1974, with only a few noteworthy exceptions.

Individual banks, obviously, have restructured their portfolios, reducing glamour stockholdings in the process. Morgan Guaranty Trust Co., of New York, for example, has sold millions of shares of more than a dozen growth stocks since 1974. But other banks, apparently, have been the buyers. For bank trusts as a group, the reduced portfolio weightings of the old favorites have come about more because of their sharp drops in price than because of wholesale dumping of portfolios.

Data are sketchy on most other institutions' transactions, but if any meaningful "distribution" of the old growth stocks was done by anyone, it seems to have been done by mutual funds. In almost every case, the mutual fund sector's percentage of ownership of shares outstanding has been reduced since 1974.

The accompanying table shows how the percentage ownership of a group of the banks' largest holdings of growth stocks changed between the end of 1974 and March 31, 1977, and what happened in the same period to holdings of those stocks among mutual funds. The data were compiled from Spectrum, a publication of Computer Directions Advisors, Silver Spring, Md. It covers about 170 bank trust departments reporting to the Comptroller of the Currency and nearly all mutual fund portfolios.

[In percent]

	Bank-owned		Fund-owned	
	Dec. 31, 1974	Mar. 31, 1977	Dec. 31, 1974	Mar. 31, 1977
IBM	21.5	22.5	5.1	4.5
Kodak	17.4	20.7	4.5	3.2
Am. Home Prod	25.5	28.8	3.3	2.0
Merck	26.3	26.0	4.3	4.0
Lilly	26.3	29.9	3.3	1.9
Procter & Gamble	17.3	21.6	1.6	1.3
Sears Roebuck	15.0	15.8	1.3	1.6
Xerox	25.7	24.4	6.9	5.5
Schering-Plough	29.7	33.5	2.8	2.3
Kresge	29.8	34.5	8.0	6.9
Coca-Cola	19.3	20.8	2.0	2.1
Avon Products	23.7	22.9	7.5	7.1
McDonald's	26.2	24.3	16.3	8.0
Digital Eq	25.6	33.7	19.1	15.7

Misconceptions of another sort lie in wait for market students who jump to conclusions about mutual fund sales and redemption activity. Fund trends are followed by some for signs of when the funds might again become net buyers of stock.

On the surface, the sales redemption picture looks much improved. The Investment Company Institute's monthly reports show conventional mutual funds' sales of their own shares to investors exceeded redemptions in two of the first four months of this year. From January through April, ICI data show, sales exceeded redemptions by $76 million.

But anyone who thinks this means a great turnaround for equity-oriented mutual funds would be mistaken. The totals for the first four months include a relatively new product—municipal bond funds. These funds, which don't have anything to do with stocks, have racked up net sales of more than $560 million in the first four months, and they're included in the ICI totals.

When the municipal bond funds are removed from the totals, mutual fund net redemptions in the first four months come to nearly $582 million. That's a better showing than the $1 billion of net redemptions a year earlier, but still represents considerable pressure on portfolio managers to raise money for investors who want to cash in.

In fact, mutual funds have been heavy net sellers of portfolio stocks, cutting back portfolio holdings nearly $1.8 billion in the first four months. In the like months last year, fund managers were net sellers of $389 million of equities. In all 1976, they sold $2.6 billion more stock than they bought.

Appendix 2

FROM COMPENDIUM OF PAPERS FOR THE STUDY OF FINANCIAL INSTITUTIONS AND THE NATION'S ECONOMY, HOUSE BANKING COMMITTEE, 94TH CONG., 2D SESS., PART 1 (1976), PP. 211–232:

BANK TRUST DEPARTMENTS AND PUBLIC POLICY TODAY

(By Roy A. Schotland*)

1. *The Question and the Facts:*

Is there any point at which a single institutional investor—a bank trust department, or an insurance company, or a mutual fund—is responsible for so much of the buying or selling of a number of stocks that that one firm cannot avoid virtually, or actually, setting the market price for those stocks? For example, if one bank trust department in one year bought 30 percent of all the shares traded that year in International Nickel stock, then the price of that major corporation stock would hardly be a public market price. That is, the price would not reflect the balanced result of decisions by many different people and firms, with a wide diversity of views and of investment needs. Instead, it would be a price influenced or virtually set by the decision of a handful of people on one committee in that one trust department.

This is not a hypothetical question. In 1975, the nation's largest institutional investor, the Trust and Investment Division of the Morgan Guaranty Trust Company in New York, bought 31 percent of all the shares of International Nickel traded that year. In 1974, the Morgan bought enough International Nickel to account for 25 percent of all trading in that stock.[1]

The Morgan's activity in Nickel is not a "sport", but rather part of a consistent pattern of dramatic dimensions. In 1973, 1974, and 1975 (the only years on which data are available), there were 128 instances

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*Professor of Law, Georgetown University Law School. Paper prepared for the *Financial Institutions and the Nation's Economy (FINE)* Study of the House Committee on Banking, Currency, and Housing.

[1] All volume figures include, in addition to the volume on the NYSE itself, the volume traded in those NYSE-listed stocks on regional exchanges—the Midwest, Pacific, PBW, Boston and Cincinnati—and in the "Third Market," i.e., over the counter.

Data on purchases, sales and holdings have been reported on a quarterly basis to the Comptroller of the Currency by large trust departments in national banks since 1974. The Federal Reserve Board, responsible for supervising state-chartered member banks' trust departments, does not assure similar reporting by banks within its jurisdiction, an inexplicable and unexplained lapse. Within the FRB jurisdiction are such major trust departments as the Morgan, Bankers Trust (3rd), U.S. Trust ( ), and Manufacturers Hanover (7th).

The Morgan voluntarily reports full data to the Comptroller, as do a few of the other state-chartered banks. However, data as called for by the Comptroller are exceedingly, almost defiantly, difficult to use, and cumulating figures for a year would be an inordinate task. The 1973 and 1974 cumulated data used here are from the Morgan's own "annual reports" (Reports III and IV) for its Trust and Investment Division. The 1975 data were made available for use by the FINE Study shortly before their regular publication in cumulated form so that this analysis could be undertaken, although not released until after the Morgan's own release (Report V).

Roy Schotland, a consultant to the FINE Study, and James Pierce, the Director of the Study, are indebted to the officers of the Morgan for this invaluable aid and cooperation, particularly noteworthy in light of their prior knowledge of the analysis being made.

Appreciation is due also to Computer Directions Advisors Inc. (Silver Spring, Md.), who regularly digest and publish, in form usable for most purposes, the data collected by the Comptroller, and particularly to Mr. Spiros Kripotos of CDA; and to Ethan Hilton Siegal and John R. Youngken of the FINE staff, who had the patience and good humor to prepare the data for 1974 and 1975.

Of course any errors are the sole responsibility of the author.

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in which the Morgan's net purchases or net sales of NYSE stocks exceeded 5 percent of total purchases or sales in those stocks. In 16 of those instances, the Morgan accounted for over 20 percent of all buying or selling.[2]

Note that these figures refer *not* to the amount of Nickel or other shares outstanding, but rather are percentages of a year's trading in those stocks. Some stocks trade or "turn over" each year only a tiny proportion of their total shares outstanding, other stocks turn over more than the total outstanding. The larger the company, of course, the less likely that its turnover will be as large as the total outstanding, unless the situation is highly speculative.

Most discussions of whether institutional investors "control" or "influence" the operating corporations in which they own stock has been in terms of the proportion of the outstanding stock held by one trust department, or perhaps by the "big six" trust departments in New York City, or by trust departments as a category. Large trading is obviously also important in evaluating institutional investors. It is trading that determines the stock's price, even if total trading volume is only a small fraction of the total shares outstanding. Thus a single investor's large trading, by its significant if not even determinative effect on the price, has important impacts on the corporation, the other shareholders and potential shareholders, and even upon stocks in the same industry whose prices usually tend to be affected together. It is impossible to measure how much price impact such trading does have, because so many factors go into each stock's price at any moment. But it defies belief that massive buying or massive selling would not have at least significant impact, at least in the short run. In the long run, the price will be determined by factors external to any one institutional investor's control or judgment, but of course the long run itself is likely to be affected, at least in a significant number of instances, by those short-run impacts.

The Morgan trust department's trading is analyzed here because it is not only the largest institutional investor, with a portfolio of equities amounting to $15.4 billion as of end-1975, but also because it is vastly larger than any other: The second-largest trust department, Citibank, had only two-thirds as much equities, $10.3 billion. To get perspective on such figures, note that the *combined* equity holdings of *all* life insurance companies totalled about $28.3 billion at the same

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[2] The 128 instances are set forth in detail at the end of this paper, in tables 5-7. For explanations of the sources and calculations of "net purchases," "net sales" and volume figures, see Appendix 1.

The 128 instances do not include other instances of heavy trading in unlisted securities on which trading data are not available or have only recently become available. For example, in 1974 Morgan's fourteenth largest purchase was $23.1 million worth (664,900 shares) of BankAmerica, which trades over the counter. They also bought $18.8 million worth (472,880 shares) of Connecticut General Insurance Corp., also over the counter. Those purchases were, respectively, 5.8 and 8 percent of the total trading in those stocks for that year. All figures include only companies with $100 million or more.

Moreover, the precise percentages of buying or selling done by the Morgan in these 128 instances actually considerably understate the significance of the Morgan's trading, relative to other institutional investors and the rest of the public. This is so because a substantial proportion of all volume is accounted for by NYSE member firms' trading, such as the "specialists" who make markets on the floor, or the "block positioners." Member firm activity accounts for different proportions of total volume in different stocks, and data are not available stock by stock. On average, member firms account for 20-25 percent of all buying or selling in a stock (Needham, "Our Kind of a Central Auction Market System," Commercial & Financial Chronicle, Sept. 20, 1973, pp. 1, 4.) Therefore, if the Morgan accounted for 30 percent of the buying in Nickel, the rest of the public probably accounted for not the remaining 70 percent, but only about 45-50 percent—not even twice as much as the Morgan alone—with the balance accounted for by member firms.

time.[3] In no way does this analysis impute any impropriety to the Morgan; indeed, like many other observers, I consider both that bank and that trust department unsurpassed in their operation and integrity.

Total asset size shapes the pattern of both holdings and trading. Many bank trust departments are large enough to show what huge size means in terms of holdings—concentration in major corporations—but only the Morgan is already large enough to show dramatically what great size means for trading patterns. The examination is worthwhile because institutional investors generally, and bank trust departments particularly, are growing rapidly. What is occurring in significant degree at only the Morgan today, will spread. A protective limitation, which paradoxically has long been law for much smaller institutional investors, is recommended in Section 4 below for all institutional investors.

The full picture of the Morgan's major trades in 1975 and the other two years for which data are public, 1973 and 1974, appears in Table 1, showing large *net* purchases or *net* sales, but *excluding* stocks in which large activity occurred in both purchases and sales.[4]

TABLE 1.—NUMBER OF NYSE STOCKS IN WHICH MORGAN ACCOUNTED FOR MORE THAN SUBSTANTIAL PERCENTAGES OF TOTAL PURCHASES OR SALES IN THOSE STOCKS FOR THE YEAR, BY MORGAN'S NET PURCHASES OR NET SALES[1]

Morgan alone accounted for more than—	1973 Purchases	1973 Sales	1973 Total	1974 Purchases	1974 Sales	1974 Total	1975 Purchases	1975 Sales	1975 Total
5 percent of total	[2] 25	16	41	19	14	33	33	21	54
10 percent of total	10	8	18	12	6	18	19	7	26
15 percent of total	6	5	11	6		5	15	2	17
20 percent of total	3	2	5	2		2	9		9
25 percent of total	1	1	2	1		1	6		6
30 percent of total	1	1	2				4		4
35 percent of total							1		1

[1] For notes explaining "netting" and total volume, see appendix 1.
[2] Numbers in each line of course include numbers in lower lines. Thus, in the 1973 purchases column, Morgan volume was 5 to 10 percent in 15 stocks, and over 10 percent in another 10 stocks, etc.

The dry data of Table 1 are a mere skeletal summary of a stunning story, appreciated only by remembering just how major are the stocks, and just how massive the trading, reflected in this Table.

In 1975, the Morgan accounted for net purchases of Kaiser Aluminum amounting to 38.5 percent of total trading; in Crown Zellerbach, 28.6 percent; in Manufacturers Hanover, another New York bank, 24 percent. In sum, there were 6 stocks in each of which the Morgan's

[3] For fuller data on asset sizes, see Section 2 below. The life insurance figure, up from 1974's $21.9 billion, is a preliminary estimate made in April 1976 by the primary data source, the Institute of Life Insurance.

[4] This exclusion, fully explained in Appendix 1, leads to another understatement of the Morgan's relative impact. (For the first causes of understatement, see n.2 *supra*.) Some few of the excluded stocks may have involved concurrent trading with the Morgan's buying and selling neutralizing each other, with little if any price impact. Such stocks cannot readily be distinguished from others in which, say, heavy buying for five months was followed by a switch and then heavy selling for 7 months, with either the buying or selling—or both—being large enough in volume to affect the price. Because of the difficulty of distinguishing between concurrently traded and "switch" stocks, it seemed more conservative in light of the thesis of this paper, to understate the significance of the Morgan's trading and show *separately* the excluded stocks, as in Tables 5c and 6c. (No separate data are presented on 1973, although there were instances that year similar to those shown for 1975 in Table 5c and 1974 in Table 6c.)

buying alone, or Morgan selling alone, accounted for more than 25 percent of total trading; in 26 stocks it was over 10 percent and in 54 stocks, over 5 percent.

Nor is 1975 at all unusual. In 1974, the Morgan's buying alone, or its selling alone, accounted for more than 5 percent of total trading in 33 stocks; in 1973, 41 stocks. There are no public data for earlier years. And these total numbers do not include stocks in which Morgan's purchases and sales combined, amounted to over 10 percent of total trading. For example, in 1974 in Philip Morris Inc., the Morgan's sales accounted for 10 percent of total trading, and it also bought enough Philip Morris to account for yet another 5 percent. Perhaps the buying and selling were concurrent, but probably a switch was made in mid-year.

In addition to the examples already mentioned, we find among the 128 instances a number in which the Morgan's heavy volume continued beyond a single year. For example:

International Flavors & Fragrances, Morgan's net sales in 1975 were 16 percent of all sales, after 1974 had seen sales amounting to 7 percent as well as purchases amounting to 9 percent of all IFF shares traded that year.

Baker Oil Tools, net sales of 15 percent of all trading in 1975 and 10 percent in 1974.

Schlumberger, net sales of 11 percent of all trading in 1975 and 12 percent in 1974.

Ralston Purina, net sales of 13 percent in 1975, after net purchases of 9 percent in 1974 and 32 percent in 1973.

In order to do so much buying or selling with as low an impact on price as possible, the Morgan spreads its activity over many days.[5] Given the volume of activity, any other course would produce extraordinary volatility in price, probably to the detriment of the trust accounts and certainly to the detriment of an orderly market. Despite the fact that the trading is spread out as carefully as possible, can anyone doubt that the Morgan's presence is itself a virtual or perhaps actual price-setter when, e.g., in 1975 they were selling IBM on *all but* 12 days that the NYSE was open, Schlumberger on all but 13 days, Kodak on all but 17 days and Xerox on all but 18 days? Here again, these figures are part of a consistent, inevitable pattern. In 1975, they traded each of 10 different stocks on more than 200 of the 253 possible days, in 1974 9 stocks, and in 1973 11 stocks.[6]

2. *Why does this occur?*

Commercial bank trust departments are the nation's largest investors, by an immense margin. Trust departments' equity portfolios

[5] Once again, the Morgan has voluntarily disclosed the precise number of days' trading for each of their top 50 purchases and top 50 sales, since 1973. See Reports III, IV and V.

Citibank was the first major trust department to disclose significant information about its activities, early in 1972, and also the first to disclose its major purchases and sales (on 1973). Morgan has been only months behind, and each bank has, each year, improved and enlarged the information given. Comparing those two, year by year, shows a fascinating competition beneficial to the public interest.

It is sad that so few other trust departments have made any similar disclosure, and that the handful which have, have hardly gone beyond barest-bone listing of their largest stock holdings. In short, trust department disclosure appears to be one more instance in which private sector forces can work admirably, but do not.

[6] In 1973 there were 252 days of trading.

are so much greater than other institutional investors that they are almost double the *combined* stock holdings of insurance companies, investment companies, foundations and endowments.

Consider the last firm data available, end-1974:

TABLE 2.—TOTAL ASSETS AND EQUITY HOLDINGS OF INSTITUTIONAL INVESTORS, END 1974[1]

[In billions of dollars]

	Total assets	Equity holdings
Commercial bank trust departments	325.3	171.3
Life insurance companies	263.8	21.9
Property and casualty insurance companies	81.8	9.8
Investment companies	54.0	34.0
Foundations	29.9	18.0
Educational endowments	12.1	6.1

[1] See app. 2 for explanation of sources of, and gaps in, this kind of data.

Not only are bank trust departments a huge, even gargantuan presence in the equity markets, but there is a high degree of concentration among them:

TABLE 3.—SIZE DISTRIBUTION OF COMMERCIAL BANK TRUST DEPARTMENTS, DECEMBER 1974[1]

Size (dollar assets)	Number of trust departments	Percent of trust departments	Total trust department assets (millions)	Percent of trust departments assets	Total assets of those banks' commercial departments (millions)
Under $10,000,000	2,805	70	$5,272	2	$103,863
$10,000,000 to $25,000,000	418	10	6,748	2	44,327
$25,000,000 to $100,000,000	454	11	22,846	7	86,286
$100,000,000 to $500,000,000	222	6	47,419	15	120,070
$500,000,000 to $1,000,000,000	40	1	27,460	8	59,035
$1,000,000,000 and over	60	2	215,582	66	335,757
Total	3,999	100	325,328	100	749,337

[1] Compiled from FRB/FDIC/OCC, Trust Assets of Insured Commercial Banks, 1974.

The seven biggest trust departments, six of them in New York City, managed $86 billion, or just over 25 percent of the total trust assets managed by all 3,999 trust departments in 1974. (In order of size: Morgan, Citibank, Bankers Trust, Chase Manhattan, U.S. Trust and Manufacturers Hanover—the Mellon National is the 5th largest.)

Concentration data would be much more extreme today, as the stock market has risen 50 percent (measured by Standard & Poor's 500, which ended 1974 at 68.56 and stood at 102.77 at the close of 1976's first quarter), and the larger the trust departments, the larger the proportion of assets in equities. Moreover, the larger the trust department, the larger the in-flows of additional funds; this is so because employee benefit accounts are the major source of net new in-flows, and those accounts cluster overwhelmingly in the biggest trust departments:

TABLE 4.—SIZE DISTRIBUTION OF EMPLOYEE BENEFIT ASSETS UNDER MANAGEMENT BY COMMERCIAL BANK TRUST DEPARTMENTS, DECEMBER 1974 [1]

Size (dollar assets)	Trust departments	Percent of trust departments	Total employee benefit assets in trust departments (millions)	Percent of employee benefit assets in trust departments
Under $10,000,000	2,805	70	$648	1
$10,000,000 to $25,000,000	418	10	1,027	1
$25,000,000 to $100,000,000	454	11	3,596	3
$100,000,000 to $500,000,000	222	6	10,545	8
$500,000,000 to $1,000,000,000	40	1	7,761	6
Over $1,000,000,000	60	2	103,107	81
Total	3,999	100	126,686	100

[1] Compiled from FRB/FDIC/OCC, Trust Assets of Insured Commercial Banks, 1974.

Concentration in the seven biggest trust departments as to employee benefit assets managed is high indeed: As of end-1974, those seven managed about $51 billion of employee benefit plan assets, or nothing less than 40 percent of the total of such assets managed by all 3,999 trust departments. This category of accounts, the fastest growing and most equity-oriented, would show vastly greater dollar figures today,[7] and would very likely also show greater concentration.

As a result of the size of the major trust departments' assets, they are able to invest only in very large corporations, with huge values and numbers of outstanding shares. (Most departments do invest small portions of their assets in small companies, even venture capital ones, but the total magnitude of those special positions is minor.) Smaller stocks could not receive the huge investments major trust departments make, without their prices becoming distorted and their companies controlled. Also, the trust departments would face grave difficulty in selling any holdings in smaller companies, unlike the high liquidity of the major corporation stocks in which almost all institutional investors, by necessity, hold most of their equity assets.

The Morgan is the biggest of all—$23 billion in trust department assets at end of 1973, $17.8 billion at the stock market bottom in end-1974. At end of 1975, although precise figures are not available yet, Morgan had about $22.5 billion. In equities alone, the Morgan had $15.4 billion, $14 billion of which was in NYSE companies, as of end-1975.[8] So heavy is the flow of new funds into the Morgan that it averaged, according to the last data available (1970–72), $859 million per year simply in existing employee benefit accounts' net in-flows.[9]

[7] According to an April 1976 preliminary release from the SEC, private noninsured pension fund assets rose $33.9 billion in 1975, and State and local government pension fund assets rose $12.6 billion. Bank trust departments manage most such assets.

[8] Computer Directions Advisers, Spectrum 4: Bank Portfolios (Dec. 31, 1975), p. 349.

[9] Answer to Questionnaire submitted to 25 largest bank trust departments, Appendix to Hearings on Financial Markets, Subcommittee on Financial Markets, Senate Committee on Finance, 93rd Cong., 1st Sess. (1973), p. 6.

Such size includes large holdings in particular companies, such as these as of end-1975:

Stock	Morgan held—percent of outstanding shares	Market value of Morgan's holding (millions)	Morgan's net sale or net purchase accounted for 5 percent or more of total: 1973	1974	1975
American Home Products	5.67	$296.7	Yes	Yes	Yes.
Goodyear Tire	9.97	155.3	Yes	Yes	Yes.
International Paper	10.09	257.7	No	Yes	Bought 7.2 percent, sold 2.8 percent.
International Nickel of Canada	6.58	123.8	No	Yes	Yes.
Kresge, S. S	7.01	282.4	Yes	No	No.
PepsiCo	9.93	165.0	Yes	Yes	Bought 8.2 percent, sold 6.1 percent.
Philip Morris	5.94	186.7	Yes	Yes	Yes.
Schlumberger	6.11	261.0	No	Yes	Yes.

The Morgan held, at end-1975, over 5 percent of the outstanding shares of 85 companies, taking *only* companies worth *at least* $200 million. This compares with 63 such holdings at end-1974 and 74 at end-1973.

The Morgan's heavy trading situations are overwhelmingly in stocks in which their holdings exceed 5 percent of the outstanding shares. Of the 128 "heavy net trading" instances reflected in Table 1 above, 89 involved holdings above 5 percent in the pertinent period: that is, if there was a "heavy" sale in 1975, there was a holding above 5 percent at the beginning of that year; if there was a "heavy" purchase in 1974, there was a holding above 5 percent by the end of that year or of 1975. If we exclude from the 128 instances the 19 on which full data are unavailable (2 in 1973) or on which the pertinent period is still open (17 of the 33 purchases in 1975), we come to 109 heavy trading instances, of which 89 involved holdings of over 5 percent.

That the Morgan's trading pattern is the result of the size of its holdings, and not of any propensity to trade actively, is obvious from noting that its turnover even in its *most* actively traded category of accounts, employee benefit accounts, is consistently much lower than found in other kinds of institutional investors—and even notably lower than Citibank's turnover:

EQUITY TURNOVER RATES [1]

	1971	1972	1973	1974	1975
Morgan employee benefit accounts	16.5	11.5	9.0	8.3	15.5
Citibank employee benefit accounts	22.5	16.9	13.8	12.0	15.7
Total selected institutions	30.8	21.8	23.5	19.1	23.0
Private noninsured pension funds	22.1	19.7	17.3	14.1	18.3
Open end investment companies	48.2	44.8	39.0	30.3	35.8
Life insurance companies	31.0	29.5	25.0	18.8	20.6
Property-liability insurance companies	23.2	23.8	20.3	22.4	23.8

[1] Turnover is defined for these purposes as the average of total purchases and sales divided by average market value of equity assets. This is the standard measure of market activity by a manager or portfolio.

Source: Securities and Exchange Commission Statistical Bulletins, and Morgan and Citibank trust reports.

It follows inexorably from sheer size that the Morgan's trading is the largest presence, exerting the largest impacts.[10]

3. *What of it?*

We promote our equity markets, and since the Securities Act of 1933 we have protected our vast public interest in them, because they are so crucial a system for linking savers and users of capital. The value of any given corporation is a disputable matter, but our public auction markets—for all their fads and other imperfections—perform a valued price-setting function precisely because of the relatively full disclosure of relevant information, and participation by a great number of diverse individuals and institutions, with diverse investment needs, timing, understanding and judgment. If many participants are wrong about what is a realistic price for a particular stock, "the market" is highly likely to correct that error as participants with better information or judgment try to take advantage of what they deem an error. As time passes, the "correct" judgment tends to become clear.

In recent years, the growth of institutional investors, combined with

[10] The second-ranked Citibank, though until very recently far behind Morgan in size, still seems far behind so far as pertinent here. At end-1975, Citibank's trust department assets were $21.8 billion, a soaring 40 percent rise from $15.6 billion in 1974, which in turn was only a tiny fall from end-1973's $15.7 billion. Citibank Investment Management Group, Review of 1975 and Review of 1974.

In contrast to the Morgan's $15.4 billion in equities at end-1975, Citibank had only $10.3 billion. Interestingly, Citibank was slightly more concentrated than was Morgan in NYSE companies, 93.6 percent to Morgan's 91.2 percent. More interesting, and troublesome, is Citibank's high concentration in holdings of a single industry: 13.1 percent of its equities are in one industry and 12.3 in another, compared to the Morgan's maxima of 10.5 percent and 8.2 percent. These high concentration figures suggest that when Citibank does have as huge an equity portfolio as Morgan has, Citibank's trading is likely to be even more cause for concern than Morgan's.

Some of Citibank's growth is attributable to Citibank's willingness to accept "directed trusteeships", a troublesome concept which the Morgan rejects. These are accounts over which a bank, although appearing to serve as a full, formal trustee, exercises no investment power at all, but instead agrees to follow directions from an outside investment adviser. Total assets in such accounts at Citibank now amount to $1.8 billion, most of which has come within the past two or three years.

"Directed trusteeships" are troublesome, in terms of misrepresentation to account beneficiaries—particularly in the employee benefit situation—as to who is exercising what responsibility over their account, and also in terms of potential bank liability for such misrepresentation and for failure to meet the responsibilities inherent in being a trustee. A limited explanation and defense of "directed trusteeships", by the Bankers Trust trust department officer in charge of new business, appears in American Banker, Jan. 13, 1976, p. 2.

To the extent that assets "under management" in a trust department are not in fact under their investment management, of course trading is likely to be more dispersed. While the thesis of this paper is that dispersion of trading is important, the goal is to be met by dispersion of assets under many managements, not by having some managements serve both as true trustees and pseudo-trustees.

an especially sharp decline of individual investors, has stirred widespread concern. Institutional dominance of the markets has some affirmative aspects, such as the hope that the markets will become more efficient. But such dominance also has its negative side, in terms of impacts on other stockholders, on the companies whose stock is so held, also on the companies which may be simply too small to be of interest to the large institutional investors, and even on the markets themselves. These matters have been much considered elsewhere.[11]

Concern over the growth of institutional investors generally is magnified greatly if any one institution, or handful of institutions, is so large that it (or they) dominates (or dominate) the market in important stocks, frequently and as a consistent pattern. Such domination is occurring today by sheer force of size at only one institution. As other institutions continue the growth they have been enjoying, while of course the market as a whole is also growing, the institutional share has risen steadily with many if not most of the largest institutions growing fastest. This distribution of growth is occurring primarily because the fastest growing source of new dollars for equity investment, employee benefit accounts, is so largely managed by the largest trust departments. Even if one were not concerned by a pattern of heavy trading on behalf of the Morgan alone, this is the ripest time for guarding against the spread of such dominant or unduly influential trading.

We should not allow any single committee of investment managers in any single institution to dominate major segments of our equity markets. Such domination threatens the soundness of market pricing, the safety of investors' portfolios—especially employee benefit portfolios, in which the public interest is acute—the independent judgment of operating corporations' managements, and public confidence.

Because sheer size means that a giant institutional investor's major trading must be spread over relatively lengthy periods, as is the Morgan's, some people argue that those institutions' performance will suffer, and portfolios or new funds will flow away to smaller money managers. In short, some argue that free market forces will solve any problem here. Such a view rests on three questionable assumptions: First, that view assumes that the giant money managers' massive trading has no price impact in itself, or very little, whereas such huge trading may well have enough self-fulfilling price impacts to make up for any disadvantages caused by the drawn-out moves. Not even most large institutional investors, let alone smaller ones and individuals, are at all likely to validate their own investment judgments by the impact of their buying or selling, since their orders are too small relative to the market. But if one or a few institutions can frequently buy or sell as much as 25 percent or more of all shares traded in a stock, self-validation becomes likely. Second, even if the giant's performance does suffer, will it suffer so much as to cause business to go elsewhere? The argument assumes highly rational selection of money managers, whereas many factors go into such selections, including other relation-

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[11] See, e.g., the useful compendium, The Rule of Institutional Investors in the Stock Market, briefing material for the Subcommittee on Financial Markets, Senate Committee on Finance, 93rd Cong., 1st Sess. (July 24, 1973).

See also my testimony, Hearings on Stockholders Investment Act of 1974, Subcommittee on Financial Markets, Senate Committee on Finance, 93d Cong., 2d Sess. (February 1974), at 56–91.

ships with the investment manager. Last, the argument assumes that market self-correction will occur in sufficient magnitude, and soon enough, to provide adequate protection of the public interest. In fact, trends thus far make clear that the giant institutional investors are continuing to grow very substantially, not shrinking. Moreover, there is little reason to limit ourselves to hoping for self-correction, when simple, unintrusive corrective steps are available.

As the few major trust departments continue to grow, whether or not the Morgan's size leads the field as it has in the past, we are likely to see such massive trading presences becoming even more massive and emerging in a steadily expanding number of stocks. Trading styles differ, but the over-riding determinant is sheer size. Such size defies any significant improvement over what we are experiencing, during the three years on which we have data, from the Morgan. As put unforgettably by the master stylist of financial journalists, Alan Abelson of Barron's, "(F)or the megabuck mastadons to become [any other kind of] traders is as credible as Dumbo doing a *pas de deux*." [12]

4. *What Should be Done?*

To limit the amount of trading any investor can do is utterly unfeasible. Causes of trading activity vary, proportions of turnover vary, and general measurements to be imposed on everyone would be as easy to put together as a holy fleece. Also, if a particular company or industry is suddenly struck by a blessing or a disaster, institutional investors—which are, after all, intermediaries for masses of individuals—must not be barred or limited from taking timely advantage of, or timely self-protection against, such events. Last, restricting any one period's trading by any one investor would only cause price distortions, or at the very least would lower confidence in market prices because fears would rise of what pent-up trading might still be coming. Trading limits have more need and more feasibility in commodities markets, and for the small category of corporate "control persons", but I know of no stock market observer who believes that trading limits on institutional investors can work in our equity markets.

Nor is disclosure an answer. Of course the recent required increase in trust department disclosure is important and valuable, but it is not a full solution for all problems. Simple disclosure of holdings, or of trading done, is a small corrective at best for the problem of dominating a stock's trading. And disclosure before trading is done would wholly distort the reliability of market prices as reflections of transactions, and would nearly or wholly destroy the ability of an institution to carry out its investment decisions.

The surest solution is indirect but sure enough, it has almost no socio-economic (or other) costs, and it even has beneficial byproducts. As Senator Bentsen and others have proposed for several years, no single investment management firm, whether bank trust department, insurance company, investment adviser or whatever, should be able to manage unlimited amounts of the outstanding stock of any single company.[13] (No divestitures would be required, lest the market be dis-

[12] Barron's, December 8, 1975, p. 1.

[13] See Hearings on Financial Markets and on Stockholders Investment Act of 1974, Subcommittee on Financial Markets, Senate Committee on Finance, 93rd Cong., 1st and 2nd Sess. (1973–74).

rupted and account beneficiaries possibly injured by untimely sales, as transition is made to new legal limits meant to improve the market and to safeguard account beneficiaries. Also, the holding size limit would be subject to exceptions at least (a) for an appropriate fraction of the assets under management to be placed in small companies, lest venture capital be yet harder to secure; and (b) for close corporations held in trust or estates.)[14]

If a trust department can hold only, say, 5 percent of the outstanding shares of any single large corporation, then the largest trust departments will have to increase the diversification of their holdings, or slow their overall growth in assets, or both.

As a matter of fact, many major trust departments already practice a self-imposed limitation on the relative size of their holdings.[15] Thus this proposal would merely apply to all investment managers what many of the industry leaders already profess and practice as sound policy. However, many trust departments do not so limit themselves. As of end-1975, Citibank had 29 above-5 percent holdings in companies worth at least $200 million, and recall that the Morgan had 85 such holdings, including seven holdings of over 10 percent in such major firms as International Paper, Chesebrough-Pond's, and Burlington Industries.

Similar holdings limits have governed insurance companies for generations, under state laws, and investment companies ever since they were "chartered" by the Federal Investment Company Act of 1940.

The result of adopting a holdings limit will be two-fold. First, large trust departments will go further to diversify (a small trend away from the 1965–74 extremes of institutional faddism and favoritism has developed recently). Second, trust assets will, beginning at once, gradually but steadily tend to spread among a greater number of banks and other investment managers. This is bound to occur as new accounts will avoid the handful of gargantuan trust departments which will already be at their holdings limits in, say, IBM and similar institutional favorites, so that a new account could not be invested in any of those stocks. For the same reason, even some existing accounts are likely to reduce their additions to funds managed by the gargantuans.

The resulting increase in diversification of holdings within the huge trust departments, and in dispersion of trust assets among a larger number of trust departments and other investment managers, will go far toward reducing any one (or a few) institutional investor's domination of trading. Of course, even with a holdings limit of, say, 5 percent of a company's outstanding shares, there could and will still be instances of relatively massive trading by a single institutional investor. But the limited size of holdings will greatly reduce the likely magnitude of any such instances, and the frequency of occurrence of

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[14] While Senator Bentsen has limited this proposal to employee benefit plan assets, probably that limitation arises from his own jurisdictional focus as a Member of the Finance Committee, for the principle is not so limited. On the other hand, even if the holding limitations were applied only to employee benefit assets, the bulk of our concern would be met, for that category of assets, vast indeed today, is growing vastly faster than any other. See n. 7, *supra*.

[15] See answers of 22 largest bank trust departments to Questionnaire, Question 13, in Appendix to Hearings, *supra* (1973).

such instances would also be greatly reduced. In the case of the Morgan, as noted earlier, during the past three years such a holdings limit would have prevented 89 of the 109 heavy-trading instances on which full data are available (or of the 128 total heavy-trading instances), in which the Morgan's net buying or net selling came to over 5 percent of total trading.

Thus, even if general institutional dominance of the stock markets rises still further, the markets will be more healthy with a safeguard that prices will reflect the judgments of a substantial number of institutions, with a substantial variety in their timing and perspectives. Further, as by-product benefits of the holdings limits, institutional investment portfolios will be more sure to be prudently diversified, and the companies whose shares are held in such portfolios will have less fear of inappropriate institutional influence, let alone control.

Would there be any negative impact? No, unless one believes that slowing the infinite growth of the "big six" New York City trust departments (plus the Mellon, which is No. 5), would be a negative.

The argument that a holdings limit is not needed, because private decisionmaking will meet any real problems here, ignores a great deal of history in securities markets, in banking and elsewhere, which shows, first, how often and how much harm to the public interest occurs in the interim; second, history which shows the uncertainty that the public interest will be served after all: and last, history which shows the certainty that in our fortunately pluralistic society, there are large divergences between private interests and the public interest. Often the public interest is best served by the clash of private interests, but many other times it must be implemented by special regulatory intervention to assure that we will remain pluralistic. If the regulatory intervention can be simple and almost entirely self-enforcing, as here, then the choice is easy—as it is here.

5. *Is This the Only Public Policy Problem Presented by Trust Departments Today?*

No. However, full consideration of such other major questions as conflicts of interest in commercial bank trust departments, or whether commercial banks have undue economic power (particularly because the \$300–400 billion in trust assets is managed by institutions with another \$700–800 billion in commercial assets), has been fully and ably handled elsewhere.[16]

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[16] On conflicts of interest, see Herman, Conflicts of Interest—Commercial Bank Trust Departments (Twentieth Century Fund, 1975). See also Herman's testimony at Hearings on Financial Institutions and the Nation's Economy, Subcommittee on Financial Institutions Supervision, Regulation and Insurance, House Committee on Banking, Currency and Housing, 94th Cong., 1st and 2nd Sess. (1975), 327–355.

Unfortunately regulatory action has not been full at all, although there is clearly sufficient statutory authority—and therefore, responsibility. The FRB has recognized the importance of trying to prevent abuses in connection with conflicts, but has done no more than advising its examiners to inquire whether State member bank trust departments with assets of \$100 million or more had written policies and procedures on potential conflicts of interest including inside information, securities trading, allocation of brokerage commissions, uninvested trust cash, proxy matters, allocation of securities, and timing of dissemination of advice. Letter from Brenton Leavitt, Director of Banking Supervision and Regulation, to FR Bank examination officers, May 29, 1975.

The Comptroller's office, which has tended to have the primary responsibility among Federal agencies for trust department supervision, has given conflicts little attention (unfortunately overlooked by the generally excellent study of the Comptroller's operations by Haskin & Sells in 1975).

The FRB and Comptroller have jointly permitted, even encouraged, one of the most widespread patterns of abuse of trust beneficiaries, the deposit of substantial amounts

The aim of this paper is to awaken recognition that we are several years into a considerable problem—and we are proceeding apace into an acute problem—of letting important parts of our public securities markets become a private jousting ground for a handful of unrestrainedly huge money managers. Unless one is more concerned about half a dozen bank trust departments in New York City and one in Pittsburgh, than about the securities markets, the 4,000 other bank trust departments, the other money managers, the corporations whose stock is being traded, and all the individuals who are directly and indirectly doing the trading, this problem can be corrected simply.

TABLES (Tables 5a to 8c)

TABLE 5a.—33 NYSE STOCKS IN WHICH MORGAN'S NET PURCHASES DURING 1975 ACCOUNTED FOR 5 PERCENT OR MORE OF ALL SHARES BOUGHT THAT YEAR IN THAT STOCK[1]

Stock	(Morgan held—percent of outstanding shares, as of end-1975)	Morgan's buying was—percent of all shares bought
Kaiser Aluminum & Chemical	(11.29)	38.5
Potlatch	(7.42)	31.4
International Nickel of Canada	(6.58)	30.8
Textron	(4.47)	30.0
Champion International	(10.82)	28.9
Crown Zellerbach	(8.20)	28.6
West-Point Pepperell	(13.46)	24.8
Manufacturers Hanover	(5.41)	24.1
J. P. Stevens & Co.	(9.53)	23.2
Burlington Industries	(11.11)	18.5
Aluminum Co. of America	(5.36)	17.6
Perkin-Elmer	(5.47)	17.2
Texasgulf	(4.07)	16.7
Phelps Dodge	(6.94)	16.3
Sterling Drug	(6.99)	15.8
Armstrong Cork	(8.40)	14.7
Illinois Power	(3.43)	12.7
Marsh & McLennan	(7.14)	12.2
Goodyear Tire & Rubber	(9.97)	11.4
Union Carbide	(3.56)	9.4
Boise Cascade	(4.26)	8.6
Inland Steel	(2.65)	8.5
Marathon Oil	(4.71)	8.4
U.S. Steel	(3.34)	8.1
Gillette	(8.12)	7.9
Hercules	(2.36)	7.1
Sperry Rand	(4.95)	7.1
Union Oil of California	(1.64)	6.6
General Electric	(1.65)	6.3
Gulf Oil	(1.07)	6.2
E. I. du Pont de Nemours	(1.35)	5.6
Stauffer Chemical	(3.37)	5.3
R. J. Reynolds Industries	(1.30)	5.3

[1] For sources and explanations of "netting" and of volume data, see appendix I.

of uninvested trust cash into non interest-bearing own-bank accounts. See Herman study, *supra*, at p. 111. This practice gives trust departments' banks undisclosed profits which, absent disclosure, belong to the beneficiaries of their fiduciary care. It also gives trust departments an unfair competitive edge over non-bank investment advisers.

The regulators and most of the industry are once again inexcusably far behind Citibank leadership. For information on their special efforts to avoid any abuses in connection with conflicts of interest, see Citibank Investment Management Group, Review of 1974, pp. 17–18 (March 1975).

Here too, inadequate regulatory protection from the bank regulators invites SEC entry. The SEC is now considering whether bank trust beneficiaries are adequately protected. See statement by Chairman Hills, Wall Street Journal, Apr. 5, 1976, p. 2.

As for treatment of the question of undue economic power, see, e.g., from one perspective, ABA, The Economic Power of Commercial Banks (November 1969), prepared by Carter H. Golembe Associates; see also Assn. of Registered Bank Holding Cos., An Evaluation of Trust Company Subsidiaries (August 1975), also prepared by Golembe Associates. See also discussion and references in Herman study, *supra*, Chapter II: The Customer Relationship and the Bank Trust Department.

TABLE 5b.—21 NYSE STOCKS IN WHICH MORGAN'S NET SALES DURING 1975 ACCOUNTED FOR 5 PERCENT OR MORE OF ALL SHARES SOLD THAT YEAR IN THAT STOCK

Stock	(Morgan held—percent of outstanding shares, as of end-1974 and end-1975)	Morgan's selling was—percent of all shares sold
International Flavors & Fragrances	(10.27, 6.63)	15.5
Baker Oil Tools	(11.37, 4.22)	15.0
Ralston Purina	(6.90, 4.64)	13.4
Philip Morris	(10.81, 5.95)	12.6
Masonite	(6.78, 1.00)	12.6
Schlumberger	(8.48, 6.11)	11.0
Chesebrough-Pond's	(12.63, 10.30)	10.4
AMP	(9.19, 7.12)	9.0
McDonald's	(10.61, 5.70)	8.9
Squibb	(10.32, 9.54)	8.6
Kraftco	(3.75, 1.90)	8.4
Schlitz Brewing	(5.00, 3.59)	8.3
Black & Decker Mfg	(4.97, 2.87)	8.1
Lubrizol	(7.08, 6.26)	6.9
American Home Products	(6.66, 5.67)	6.8
Heublein	(10.69, 9.67)	6.5
Johnson & Johnson	(2.82, 1.81)	6.4
Xerox	(5.09, 2.77)	6.1
Procter & Gamble	(4.91, 4.35)	5.6
Revlon	(5.29, 4.57)	5.4
J. C. Penney	(5.51, 4.83)	5.4

TABLE 5c.—11 NYSE STOCKS IN WHICH MORGAN'S PURCHASES AND SALES DURING 1975 WERE BOTH OF MAJOR SIZE

Stock	(Morgan held—percent of outstanding shares, as of end-1974 and end-1975)	Net percent		Shares bought	Percent of all shares bought	Shares sold	Percent of all shares sold
Citicorp	(4.70, 4.78)	Bought	.7	631,970	1.9	398,856	1.2
Dow Chemical	(1.42, 2.30)	Bought	4.4	1,007,039	5.3	178,852	0.9
General Motors	(1.91, 1.99)	Bought	.2	582,852	1.5	500,549	1.3
IBM	(4.51, 4.07)	Sold	2.0	129,506	.6	582,214	2.6
International Paper	(9.14, 10.09)	Bought	3.5	835,691	5.7	332,000	2.2
Merck & Co., Inc	(3.98, 3.43)	Sold	2.2	241,875	1.7	545,633	3.9
Pepsi Co., Inc	(9.69, 9.93)	Bought	1.6	349,355	6.1	259,385	4.5
Schering-Plough Corp	(5.16, 4.63)	Sold	2.3	391,725	3.3	661,164	5.6
Sears Roebuck & Co	(3.39, 3.21)	Sold	1.0	286,127	1.7	466,082	2.7
Caterpillar Tractor Co	(2.14, 2.82)	Bought	3.4	658,084	5.2	220,372	1.8
Kresge (S.S.) Co	(7.01, 7.01)	Bought	.1	787,287	2.4	760,474	2.3

TABLE 6a.—19 NYSE STOCKS IN WHICH MORGAN'S NET PURCHASES DURING 1974 ACCOUNTED FOR 5 PERCENT OR MORE OF ALL SHARES BOUGHT THAT YEAR IN THAT STOCK

Stock	(Morgan held — percent of outstanding shares, as of end-1974 and end-1975)	Morgan's buying was — percent of all shares bought
Goodyear Tire & Rubber	(8.36, 9.97)	25.5
International Nickel of Canada	(4.03, 6.58)	24.9
Squibb	(10.32, 9.54)	18.3
First International Bancshares	(4.82, 5.36)	16.8
Gannett	(3.00, 2.57)	15.7
Marriott	(6.83, 7.05)	15.0
Sterling Drug	(4.17, 6.99)	14.4
Gillette	(6.72, 8.12)	13.5
Phelps Dodge	(4.86, 6.94)	13.0
B. F. Goodrich	(4.39, 6.44)	13.0
Heublein	(10.69, 10.69)	12.3
Lubrizol	(7.08, 6.26)	10.3
Kraftco	(3.75, 1.90)	9.3
Ralston Purina	(6.90, 4.64)	8.8
Texasgulf	(1.67, 4.07)	7.6
Schlitz Brewing	(5.00, 3.59)	7.6
PepsiCo	(9.68, 9.93)	7.2
International Paper	(9.14, 10.09)	6.0
Union Camp	(2.01, 3.33)	5.7

TABLE 6b.—14 NYSE STOCKS IN WHICH MORGAN'S NET SALES DURING 1974 ACCOUNTED FOR 5 PERCENT OR MORE OF ALL SHARES SOLD THAT YEAR IN THAT STOCK

Stock	(Morgan held—percent of outstanding shares, as of end-1973 and end-1975)	Morgan's selling was—percent of all shares sold
ARA	(7.42, 2.81)	14.2
Howard Johnson	(12.10, 5.62)	12.6
Schlumberger	(11.74, 8.48)	12.4
Masonite	(11.61, 6.78)	12.4
Baxter Laboratories	(4.06, .94)	11.2
Baker Oil Tools	(14.48, 11.37)	10.1
Chesebrough-Pond's	(15.00, 12.63)	9.7
Upjohn	(3.75, .29)	9.4
Emery Air Freight	[1] (3.60, 3.73)	8.9
Champion International	(5.88, 4.53)	8.5
AMP	(11.29, 9.19)	7.4
Avon Products	(7.87, 6.42)	5.6
Philip Morris	(11.11, 10.81)	5.0
Schering-Plough	(6.21, 5.16)	5.0

[1] [Sic.]

TABLE 6c.—22 NYSE STOCKS IN WHICH MORGAN'S PURCHASES AND SALES DURING 1974 WERE BOTH OF MAJOR SIZE

Stock	(Morgan held—percent of outstanding shares, as of end-1973 and end-1974)	Net percent		Shares bought	Percent of all shares bought	Shares sold	Percent of all shares sold
American Home Products	(6.11, 6.66)	Bought	3.7	1,379,977	6.0	525,245	2.3
Avon Products	(7.87, 6.42)	Sold	5.0	278,105	1.0	1,006,135	6.0
Coca-Cola	(4.53, 4.78)	Bought	1.8	336,990	3.3	151,577	1.5
Dow Chemical	(1.55, 1.42)	Sold	.8	260,868	1.4	406,111	2.2
Eastman Kodak	(3.59, 3.39)	Sold	.1	277,126	1.2	280,454	1.3
Exxon	(1.52, 1.48)	Sold	.1	327,255	1.7	335,489	1.8
General Motors	(1.68, 1.91)	Bought	1.9	917,072	2.9	319,046	1.0
Halliburton	(8.15, 7.01)	Sold	2.3	105,149	1.5	268,850	3.8
IBM	(4.65, 4.51)	Sold	.9	282,336	1.8	427,095	2.7
International Flavors and Fragrances	(10.26, 10.27)	Bought	1.1	674,632	8.5	586,909	7.4
International Paper	(7.27, 9.14)	Bought	6.0	948,630	7.5	193,752	1.5
Johnson & Johnson	(2.95, 2.82)	Sold	1.3	127,090	1.6	234,363	2.9
Kresge (S. S.)	(7.02, 7.01)	Bought	.9	772,209	2.9	524,115	2.0
Lilly (Eli)	(3.37, 3.35)	Sold	.4	369,986	5.0	401,158	5.4
McDonalds	(10.94, 10.61)	Sold	.3	294,500	1.2	361,232	1.5
Merck	(4.25, 3.98)	Sold	1.5	188,272	1.6	378,408	3.1
Minnesota Mining & Manufacturing	(1.45, 1.52)	Bought	.9	294,096	2.2	181,289	1.3
Philip Morris	(11.11, 10.81)	Sold	5.0	438,188	5.3	851,977	10.3
Polaroid	(10.66, 9.29)	Sold	1.6	237,845	.9	657,205	2.5
Procter & Gamble	(5.06, 4.91)	Sold	1.0	205,320	2.3	293,952	3.3
Sears Roebuck	(3.52, 3.39)	Sold	1.1	217,575	1.7	365,591	2.8
Xerox	(5.22, 5.09)	Sold	.2	246,364	1.3	289,979	1.5

TABLE 7a.—25 NYSE STOCKS IN WHICH MORGAN'S NET PURCHASES DURING 1973 ACCOUNTED FOR 5 PERCENT OR MORE OF ALL SHARES BOUGHT THAT YEAR IN THAT STOCK

Stock	(Morgan held — percent of outstanding shares, as of end-1973 and end-1974)	Morgan's buying was — percent of all shares bought
Ralston Purina	(6.1, 6.9)	32
Richardson-Merrell	(9.7, 9.1)	22.5
National Chemsearch	(15.5, 13.9)	21.1
American Dist. Tele	(13.9, 15.8)	18.5
Schlitz (Jos.) Brewing	(4.98, 5.00)	17.4
Consol. Freight	(9.2, 11)	16.3
Coca-Cola	(4.5, 4.8)	12.8
Squibb	(9.4, 10.3)	11.7
Lubrizol	(6.3, 7.1)	10.8
American Home Products	(6.1, 6.7)	10.0
Procter & Gamble	(5.1, 4.9)	9.9
Goodyear Tire & Rubber Co	(3.8, 8.4)	9.5
Philip Morris	(11.1, 11.0)	8.9
Bristol-Meyer	(2.1, 2.5)	8.8
International Flavors & Fragrances	(10.3, 10.3)	8.1
Penney (J.C.) Corp	(6.0, 5.5)	7.7
Dow Chemical	(1.6, 1.4)	7.4
PepsiCo., Inc	(8.4, 9.7)	7.4
Lilly (Eli) & Co	(3.4, 3.4)	7.3
ABC	(4.2, 3.5)	7.0
Kraftco	(2.5, 3.8)	7.0
Kresge (S.S.) Co	(7.0, 7.0)	6.7
Marathon Oil	(2.0, 2.9)	6.7
McDonalds Corp	(10.9, 10.6)	5.8
Revlon	(4.3, 5.3)	5.1

TABLE 7b.—16 NYSE STOCKS IN WHICH MORGAN'S NET SALES DURING 1973 ACCOUNTED FOR 5 OR MORE OF ALL SHARES SOLD THAT YEAR IN THAT STOCK

Stock	(Morgan held—percent of outstanding shares, as of end-1972[1] and end-1973)	Morgan's selling was—percent of all shares sold
Revco D.S	(c. 4.25; 1.53)	32.2
Trane	(c. 7.25; 4.08)	21.3
Rite-Aid	(NA)	18.8
W.T. Grant	(NA)	16.1
L.A. Times-Mirror	(c. 5.50; 3.62)	15.9
Melville Shoe	(c. 10.0; 7.0)	14.3
Cummins Eng	(c. 9.25; 6.27)	12.8
ARA	(c. 11.25; 7.42)	12.0
Jewel Cos	(c. 3.90; 1.21)	9.3
Burlington Industries	(c. 10.70; 9.56)	9.1
Heublein	(c. 12.0; 9.34)	8.5
Carrier	(c. 11.50; 9.62)	7.7
Simplicity Pattern	(c. 16.75; 13.69)	7.7
Louisiana Land Exp	(c. 9.30; 8.02)	6.9
E.I. du Pont de Nemours	(c. 1.25; .50)	6.1
American Cyanamid	(c. 5.25; 4.15)	5.7

[1] Precise holdings percentages are not available for end-1972, and so have been closely approximated. The 1973 figures are precise.

TABLE 8a.—MORGAN'S 1973 MAJOR PURCHASES, WHICH BECAME MORGAN'S 1974 MAJOR SALES[1]

[In percent]

Stock	1973 net purchase	1974 net sale
1. Procter & Gamble Co	12.7	1.0
2. Penney (J.C.) Co., Inc	10.5	4.2
3. Dow Chemical Co	9.5	.8
4. Philip Morris, Inc	9.3	5.0

[1] This table, and tables 8b and 8c, exclude major reversals of direction which seem to have occurred during the calendar year, as distinct from those which happen to move in one direction in 1 year, then the opposite direction the next year. For example, the following is excluded from these tables because of the "netting" treatment (see app. 1):

	1973	1974	1975
Lilly (Eli) & Co	Bought 9.3 percent of volume.	Bought 5 percent; sold 5.4 percent.	Sold 4.7 percent.

TABLE 8b.—MORGAN'S 1974 MAJOR PURCHASES, WHICH BECAME MORGAN'S 1975 MAJOR SALES

[In percent]

Stock	1974 net purchase	1975 net sale
1. Squibb Corp	18.3	8.6
2. Heublein Inc	12.3	6.5
3. Kraftco Corp	9.3	8.4
4. Lubrizol Corp	10.3	6.9
5. Ralston Purina Co	8.8	13.4
6. Schlitz (Jos.) Brewing Co	7.6	8.3
7. International Flavors & Fragrances	1.1	15.5
8. American Home Products	3.7	6.8
9. Ford Motor Co	4.8	3.5
10. Air Products & Chemicals, Inc	4.9	4.0
11. Coca-Cola Co	1.8	2.3
12. Kennecott Copper Corp	2.8	4.6

TABLE 8c.—MORGAN'S MAJOR SWINGS

	1973	1974	1975
Heublein	Sold 10 percent	Bought 12.3 percent	Sold 6.5 percent.
Schering-Plough	Bought 4 percent	Sold 5 percent	Bought 3.3 percent, sold 5.6 percent.

APPENDIX 1

Notes About Data in Tables

1. *"Netting"*.—Any "netting" reduces the magnitude of the Morgan's moves. For example, in Table 1 and the underlying 1974 data (Tables 6a and 6b), I do not show Philip Morris at all as an active net purchase, and where it does appear, as an active net sale, it is shown as accounting for only 5 percent of total trading. Similarly, Eli Lilly, as a result of netting, is excluded entirely from Tables 1, 6a and 6b.

But as shown in the tables showing stocks *both* actively bought *and* actively sold (Table 6c for 1974), in fact the Morgan purchased Philip Morris actively enough to account for 5% of total trading, and sold enough of the same stock to account for 10% of the volume. "Netting" eliminates the purchase, and reduces the sale from 10% to 5% (rounded). Similarly, Eli Lilly, but for netting, would appear on the purchase side as accounting for 5% of total volume, and also on the sale side, again at 5%.

"Netting" has been done for two reasons: (1) If as a matter of fact the purchases and sales were concurrent, because of the differing investment needs of different accounts, then the Morgan's trading would have little if any price impact. In that situation, the thesis of this paper, that one institution is having an inordinate price impact, would be inflated by data where such impacts may not have occurred, and so all data which even *may* represent concurrent trading, have been excluded. (2) As a matter of probabilities, the combination of large purchases and sales in one year is more likely to result from a change in view toward the stock during the year, rather than from concurrent, offsetting transactions. That is, whether or not it was true of Philip Morris in 1974, usually 5% of the volume on the sale side in the same year as 10% on the buy side, will reflect purchases in, say, the earlier part of the year, followed by a complete switch in judgment about the stock and thus sales for the remainder of the year.

Thus as a matter of probabilities, it is likely that the Morgan's trading is heavily influencing if not setting prices even in these "netting" situations which I have excluded. Thus the data here almost certainly *understate* the frequency of Morgan's price impacts. That seemed clearly the better course than risking overstatement.

All "net" purchases or "net" sales have been adjusted only to the extent that the transactions "in the other direction"—e.g., the total sales subtracted from total purchases to arrive at "net purchases"—were substantial enough to rank among the top 50 reported. Smaller transactions "in the other direction" have been ignored because the data are not readily available; because their lesser magnitude, by definition, made their exclusion hardly likely to matter; and last, because the Morgan was active on both sides of the market in so few stocks among their 100 largest trades, further reducing the likelihood that anything of consequence is excluded.

2. *Total Volume.*—There are considerable problems to calculating "total volume," as explained fully in the letter excerpted below. There is also the problem that some volume in all "institutional" NYSE issues tends to be done on regional exchanges and in the "third market." Now, in 1976, we have daily "composite NYSE volume" reporting, but even that excludes most "third market" volume, and in any event it was not available in 1975 or earlier. Therefore, substantial efforts were made to assemble total volume figures.

When I first made this analysis of Morgan's trading volume, in May 1974 for the Educational TV Network "Advocates" program, I went so far as to cumulate volume data for the NYSE, three major regionals, and SEC-reported third-market data. That resulted in data extremely similar to simple NYSE volume, as seen by comparing Table 1 data for 1973, with the below figures which reflect NYSE-only data:

Morgan, more than—	Cumulated Table 1 Purchases	Sales	Total (stocks)	NYSE only, total, (stocks)
5 percent	25	16	41	44
10 percent	10	8	18	26
15 percent	6	5	11	13
20 percent	3	2	5	7
25 percent	1	1	2	4
30 percent	1	1	2	2
35 percent				1

In the analysis of 1974 and 1975 trades for this paper, even fuller data were available and, therefore, were cumulated so that the Morgan percentages are calculated on the basis of all trading: the NYSE itself; the Midwest, Pacific, PBW, Boston and Cincinnati exchanges; and the third market. The NYSE and regional exchange data are from the Bank & Quotation Record, issues of January 1975 and January 1976. The third market data are from dealers' reports to the SEC pursuant to Exchange Act Rule 17-a-9; the SEC publishes such data on 50 stocks in each Quarterly Statistical Bulletin, and for the remaining stocks the SEC's computer print-outs were used.

The problems of "total volume" data were set forth in the following explanation of my analysis, included in a letter of May 15, 1974 to Mr. Harrison V. Smith, then Senior Vice President, now Executive Vice President in charge of the Trust and Investment Division, Morgan Guaranty Trust Company:

Enclosed are my work papers on the Morgan's participation in the market in its major moves last year. (I apologize for sending you work papers rather than a polished final piece, but I believe they are clear and want to get the data to you as quickly as possible.) This shows Morgan volume as reported in your recent "Report III", relative to two figures: First, relative to total reported NYSE volume. Second, relative to total reported NYSE volume plus (a) total reported Midwest, Pacific and Boston volume, and (b) reported third-market volume as per SEC data secured routinely from third-market firms.

While I have no doubt about the accuracy of these figures (unless clerical errors have been made and not caught), there are minor adjustments still to be made, or which would be made if the data existed, which might cause some increases and some decreases in the Morgan's participation figures.

Thus: (1) The Morgan's participation relative to total reported NYSE volume is understated. That is, for example, in fact the Morgan accounted for *more* than 38% of actual NYSE public purchases and sales in Ralston Purina last year. This is because I do not have data on the extent of dealer participation in that total volume, and am told such data do not exist stock by stock. I understand the rough average extent of total dealer participation in NYSE volume is 20%. I expect that in these "institutional" stocks, member firms' dealer participation is usually particularly high. (2) The Morgan's participation relative to off-board volume in these NYSE stocks may be overstated for three separate reasons: (a) Annual data are available only on the three regionals included: adding the other regionals will make little change in the final figures, but I do want to add them as soon as there is time (and a research assistant) to assemble the monthly data for the other regionals. (b) In the time that was available, and with SEC's back copies of the Bank Stock Quotation Record unavailable (they're being bound), I was unable to learn whether the three regionals' figures on the few stocks which had splits, had been adjusted for those splits. I believe they were not adjusted for splits (as the NYSE data were, via long telephone call and the courtesy of staff at the Quotation Record), but while that might matter a good deal had a stock like the Times-Mirror split and the Pacific Exchange figures not been adjusted, I believe the few stocks which in fact are involved would see little change in final figures when the adjustments are made. (c) The third-market figures are understated somewhat, because the SEC secures only those firms' sale figures, whereas the "total volume" figures those firms—or, at least, Weeden—like to use, as in advertising how their volume compares with the NYSE's, are adjusted to be comparable to NYSE reporting. There appears to be a difference of opinion among highly knowledgeable people about the extent of the "lowness" of the SEC's third-market data.

In all likelihood, the three causes of possible understatement of total off-board volume are more than likely outweighed, and probably considerably so, by the one cause of definite overstatement of total on-board volume.

3. *Stock Splits.*—Three stocks reflected in Table 1, Schlumberger in 1975 and Philip Morris and Squibb in 1974, experienced stock splits during those years. (Respectively, 3 for 2; 2 for 1; and 2 for 1.) One other stock not in Table 1, but in Table 6c because of very large activity in both purchases and sales—International Flavors and Fragrances—had a 2 for 1 split in 1974.

The data on these few stocks could not be adjusted to take those splits into account precisely because of severe limits on the data available, but it is believed that this results in accurate though in these few cases imprecise figures. Thus, for example, Schlumberger, in which Morgan's sales accounted for 11% of total trading volume during 1975 was split 3 for 2 on April 16, 1975. The annual volume figures available do *not* adjust, they simply report the cumulative total number of shares traded; that is one limit on getting precise percentages of the volume. The second limit is that data are not available (except in raw form, as reported to the Comptroller—see Footnote 1 in text above) showing how much of the Morgan's activity was pre-split, how much was post-split. Thus it *may* be, depending upon when the bulk of their activity occurred, that they actually did more than 11%, or less. If their trading was relatively level throughout the year—and in the instance of Schlumberger, they traded on 240 days of the 253 days the NYSE was open in 1975, an astounding fact in itself—it seems appropriate simply to use the total Morgan figure and the total recorded volume figures.

APPENDIX 2

Sources of, and Gaps in, Data on Total Sizes of Institutional Investors' Assets

Delays in reporting the amount of assets managed by trust departments are so considerable that it will be late in 1976 before we have data on end-1975. Thus, as of early April 1976, the only firm and complete data available are end-1974, reported in a joint publication of the FRB, FDIC and Comptroller, Trust Assets of Commercial Banks—1974.

Since end-1974, stock prices have risen 50%, from Standard & Poor's 500 figure of 68.56, to 102.77 (close of 1976 first quarter, March 31, 1976).

In addition to stock price rises, bank trust departments, being the largest managers of pension fund assets, have very substantial and regular net in-flows of new funds in such accounts, as well of course as similar flows into other accounts. The last element making estimates imprecise is that the composition of assets changes, especially in a period of dramatic market moves like the recent one. Thus, at end-1974 it is likely that substantial amounts were held in cash equivalents which subsequently were moved into stocks.

The bank regulators' annual publication on trust assets, although so late, does give thorough coverage including such data as the categories or kinds of accounts (e.g., employee benefit trust, personal trust, employee benefit agency accounts, etc.), the categories of assets, and specific dollar amounts in each category of accounts managed by each of the 300 largest trust departments, which includes almost all departments with more than $100 million in assets. Unfortunately, it does not give net new in-flows, nor distinguish at all between assets over which there is investment discretion and other assets, nor give any information about voting authority.

The trust department data in this paper derive from that publication, unless otherwise indicated.

Almost immediately after that publication appears each year, the *American Banker* publishes asset and income data on the 100 largest trust departments, including comparison with the prior year.

A gap in trust department data is the exclusion from publications, and consequent ignorance or uncertainty, about how much money is in custodial accounts, for which the trust department renders only strictly ministerial services, such as collecting dividends or delivering stock certificates to a broker for sale. (The line between such accounts and "directed trusteeships," concern over which is expressed in the text of the paper, is so thin as to raise further question about the reality of any "trusteeship" if "directed.") According to a leading private publication's survey of about 1300 trust departments, total assets—

including custodian accounts—came to $140 billion in end-June, 1975, and $412 billion in end-June 1974. Money Market Directory—1976 (New York). Since our other data are end-December and the stock market has moved so in this period and the amount of in-flows is unknown, it is difficult to calculate the dollar amount in custodial accounts. (The Money Market Directory's exclusion of 2700 smaller trust departments should also be noted, but probably matters little if at all because such departments likely have so little custodial business.) Recent first-time data on custodial accounts of 23 major trust departments indicates $68.9 billion in common stock in such accounts at those banks; this includes other banks' holdings, mutual funds' holdings, etc. Institutional Investors' Common Stock, Committee Print, Subcommittee on Reports, Accounting and Management, Senate Committee on Government Operations, 94th Cong. 2d Sess., pp. 440–45 (1976). In spite of this size, the lack of knowledge about custodial accounts is far less disturbing, because of the limited ministerial powers over those accounts, than the lack of routine assembly and publication on the other quite simple matters noted above about regular trust department accounts.

Data about other institutional investors comes from the secondary assemblage of data published by the SEC, Statistical Bulletin, May 1975, p. 440; except for the figure on life insurance companies' equity holdings, which is from the Institute of Life Insurance, Life Insurance Fact Book—1975.

Appendix 3

Memorandum

(A) Market Impact of Bank Transactions

1. Bank coverage—federally chartered and selected state chartered banks reporting quarterly transactions to the Comptroller of the Currency.

2. Stock coverage—all NYSE and ASE common stocks.

3. Time coverage—quarter ended March 31, 1977 and quarter ended June 30, 1976.

4. Variables:

(*a*) Bank trans ($000)—net quarterly shares bought or sold (—) times end of quarter market price, expressed in thousands of dollars.

(*b*) Market volume ($000)—quarterly accumulation of daily consolidated volume times daily closing price, expressed in thousands of dollars.

(*c*) Trans/volume—ratio of variable (a) to variable (b).

(*d*) QTR price change—percentage change in price for the same quarter as variables (a) and (b).

(*e*) May price change—percentage change in price for the 2-month period succeeding the March 31, 1977 quarter (i.e. March 31, 1977 to May 31, 1977).

5. Procedures:

(*a*) Compute the ratio of bank transactions to total market volume in the quarter ended March 31, 1977 for each of 882 stocks bought or sold on balance.

(*b*) Compute the percentage price change for the same stocks over the period December 31, 1976 through March 31, 1977.

(*c*) Rank the stocks by the ratio computed in (a).

(*d*) Divide the stocks into 10 groups of roughly 88 companies each—top 88 sales relative to volume in group 1, next 88 in group 2 . . . and top 88 purchases relative to volume in group 10.

(*e*) Determine the average percent price change during the quarter for group; and perform a statistical analysis of variance to test the significance of any differences in average performance between the groups.

(*f*) Repeat steps (a) through (e), but calculating percent price change over the period March 31, 1977 through May 31, 1977.

(*g*) Repeat steps (a) through (e) using bank transactions, market vol- each group; and perform a statistical analysis of variance to test the significance of any differences in average performance between the groups. umes, and percent price changes for the quarter ended June 30, 1976.

6. Results:

(*a*) There is a significant positive relationship between bank transactions (relative to market volume) and percent price change for the quarter ended March 31, 1977. The 88 stocks most heavily sold during the quarter were off 8.1 percent, while the 88 stocks most heavily bought were off only 0.2 percent. (The average of all 882 stocks was —4.8 percent.) The analysis of variance F-test was 3.45, indicating greater than 99% confidence that differences in average performance as large as those observed could not have been caused by sampling error.

(*b*) There is a possibility that the relationship described in (a) was due to the market impact of the bank trades. There is also the possibility that the relationship existed because the banks made particularly astute investment selections (i.e. bought stocks that later advanced, and sold those that later declined): However, the latter hypothesis is not confirmed when we look at March 1977 quarterly transaction vs. performance for the subsequent period March 31, 1977 through May 31, 1977. There is no significant relationship between the two variables (F=0.76).

(*c*) As a check against abnormalcy of the March 31, 1977 quarter, the analysis was repeated using data for a dissimilar quarter ended June 30, 1976. (The March 1977 quarter was down 7.5 percent for the S&P 500, with income reinvested; while the June 1976 quarter was up 2.4 percent.) The 77 stocks most heavily sold (relative to volume) were off 2.1 percent in price for the quarter; the 77 stocks most heavily bought were up 4.5 percent; and the average of the 770 stocks transacted was up 1.3 percent. Again, the analysis of variance F-test, at 2.67, reflected greater than 99 percent confidence that sampling errors did not account for the sizeable differences between the average performances of the 10 groups.

7. Miscellaneous:

(a) The stocks most heavily bought and sold relative to volume seem, for the most part, to be smaller companies. Any restriction on trust department holdings which included these smaller companies might deprive them of a secondary (or even primary) market for their securities. Any restriction which exempted smaller companies would probably have little effect on the alleged problem of bank transactions impact.

(b) This study appears to support the hypothesis that the banks exert a market price pressure via their larger transactions. However, no marketplace is infinitely liquid. This study is not addressed to the underlying questions: (1) Is the pressure excessive? (2) Is the pressure harmful (and to whom)? and (3) What, if anything should be done about it?

TOP 88 SALES RELATIVE TO VOLUME

[139 banks $123,000,000,000 in common stock holdings, Mar. 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions' volume	Quarter price change
Houdaille Industries, Inc	−$3,035	$7,830	−0.3876	−12.1
Matsushita Electronic Indl. Ltd	−3,553	9,775	−.3634	−14.6
Allright Auto Pks. Inc	−399	1,148	−.3480	0
CRS Design Associates Inc	−329	954	−.3451	5.6
Mercantile Stores Inc	−3,069	9,252	−.3317	−12.4
Hotel Invs	−379	1,233	−.3071	0
Edison Bros. Stores Inc	−1,550	5,051	−.3069	−.2
V F Corp	−1,544	5,811	−.2658	−8.7
Sony Corp	−33,311	125,689	−.2650	6.8
Harvey Group Inc	−30	118	−.2515	20.0
Marriott Corp	−15,405	61,843	−.2491	−28.0
Howard Johnson Co	−7,434	31,149	−.2387	−22.0
Marsh & McClennan Cos. Inc	−9,978	42,512	−.2347	1.1
Goodrich, B. F., Co	−8,179	35,305	−.2317	13.5
Carrier Corp	−8,191	36,680	−.2233	−15.6
First Chicago Corp	−6,847	31,113	−.2199	−13.7
Zayre Corp	−915	4,203	−.2177	6.6
Richardson Merrell Inc	−3,480	16,291	−.2136	−6.8
Inco Ltd	−14,767	70,482	−.2095	−4.6
Alcon Labs Inc	−2,244	10,763	−.2085	−14.3
Cincinnati Milacron Inc	−1,189	5,753	−.2066	8.3
Bearings Inc	−1,229	6,291	−.1953	−13.8
Rexnord Inc	−3,242	16,638	−.1948	4.3
Mary Kay Cosmetics Inc	−1,782	9,180	−.1941	−26.4
Peabody International Corp	−4,020	2,[illegible]008	−.1914	4.9
Asarco Inc	−13,116	69,772	−.1880	33.6
Kollmorgen Corp	−340	1,829	−.1859	−2.2
Ennis Business Forms Inc	−122	665	−.1841	−2.0
Chemetron Corp	−1,650	9,036	−.1826	−5.5
Louisville Gas & Electric Co	−1,157	6,571	−.1761	−6.1
Illinois Power Co	−4,830	27,583	−.1751	−5.9
Lowenstein M. & Sons Inc	−382	2,198	−.1740	−13.6
Skaggs Cos. Inc	−1,512	9,730	−.1732	−22.0
Dow Jones & Co. Inc	−2,327	13,766	−.1691	−5.6
Pizza Hut Inc., Delaware	−4,223	25,110	−.1682	−28.1
Eckero, Jack, Corp	−4,289	25,589	−.1676	−17.7
Giddings & Lewis Inc	−956	5,751	−.1663	19.7
Crane Co	−2,417	15,132	−.1557	9.9
International Flavors & Fragrances	−7,126	44,746	−.1553	−7.9
Goodyear Tire & Rubber Co	−14,551	93,502	−.1556	−16.3
Continental Telephone Corp	−5,075	32,552	−.1540	−9.2
Bank VA Co	−660	4,364	−.1512	−5.7
Pioneer Corp., Texas	−3,262	21,612	−.1509	−.6
Disney, Walt, Productions	−24,433	165,418	−.1477	−26.5
Joy Manufacturing Co	−7,654	42,445	−.1459	.5
First International Bancshares Inc	−2,959	20,634	−.1454	−13.5
Procter & Gamble Co	−25,794	179,155	−.1440	−15.6
Dr. Pepper Co	−2,712	18,835	−.1440	−17.5
Lubrizol Corp	−6,006	42,969	−.1398	−14.6
Perkin, Elmer Corp	−3,592	26,225	−.1369	−15.5
Portec Inc	−1,361	9,966	−.1366	−8.7
Pacific Lumber Co	−1,394	10,451	−.1334	−17.9
Burns International Security Services, Inc	−398	3,013	−.1322	−3.8
Dun & Bradstreet Cos., Inc	−4,503	34,053	−.1322	−9.0
American Airlines, Inc	−4,135	32,840	−.1259	−24.1
Black & Decker Manufacturing Co	−6,584	52,293	−.1259	−18.6
Jonathan Logan, Inc	−802	6,407	−.1251	−11.0
International Business Machines	−195,176	1,560,372	−.1251	−.9
Mony Mortgage Investors	−809	6,527	−.1240	−9.8

TOP 88 SALES RELATIVE TO VOLUME—Continued

[139 banks, $123,000,000,000 in common stock holdings, Mar. 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions volume	Quarter price change
National Chemsearch Corp	−$1,477	$12,236	−0.1207	−29.0
Ralston Purina Co	−7,645	63,465	−.1205	−15.3
Bank New York, Inc	−1,108	9,296	−.1192	.3
Hall, Frank B., & Co., Inc	−1,005	8,528	−.1178	−20.5
Japan FD, Inc	−462	3,992	−.1158	−18.3
Delta Air Lines, Inc	−6,651	57,462	−.1157	−22.1
General Growth Properties	−430	3,725	−.1153	.6
Buehler Corp	−59	517	−.1140	−2.7
Hilton Hotels Corp	−1,256	11,258	−.1116	−12.6
Lane Bryant, Inc	−245	2,202	−.1113	0
McDonalds Corp	−24,725	228,729	−.1081	−25.5
Ferro Corp	−662	6,194	−.1069	1.2
Medusa Corp	−316	2,966	−.1066	−2.1
Knight Ridder Newspapers, Inc	−1,118	10,616	−.1053	−16.3
American Garden Products	−168	1,627	−.1031	27.1
Zenith Radio Corp	−5,055	49,713	−.1017	−11.7
Illinois Tool Works, Inc	−501	4,934	−.1016	−15.8
Media General Inc	−327	3,249	−.1008	−16.6
Allstar Corp	−980	9,886	−.0992	5.4
Transcon Lines	−200	2,047	−.0977	−12.4
Texas Utilities Co	−7,903	81,028	−.0975	−10.3
West Point Pepperell, Inc	−1,126	11,625	−.0969	−14.4
Lomas & Nettleton Financial Corp	−694	7,193	−.0965	−17.4
Federated Department Stores, Inc	−8,931	93,043	−.0960	−19.4
Cleveland Cliffs Iron Co	−1,052	11,026	−.0954	−7.1
Hoover Ball & Bearing Co	−241	2,555	−.0942	−.5
Monroe Auto Equipment Co	−1,674	17,905	−.0935	−21.1
Southland Corp	−1,543	16,588	−.0930	−18.5
Binney & Smith, Inc	−169	1,830	−.0922	3.8
MacDonald, E. F., Co	1,165	1,597	.7298	20.0
Kennametal Inc	4,710	6,759	.6969	−5.3
Carlisle Corp	1,548	2,741	.5648	19.0
Bliss & Laughlin Industries Inc	1,957	3,486	.5613	8.4
Warner & Swasey Co	2,945	5,270	.5588	0
Energy Research Corp	397	811	.4889	17.5
Allegheny Ludlum Industries Inc	7,854	16,385	.4794	−6.3
Diamond International Corp	6,796	14,309	.4749	−8.4
Ex Cell O Corp	4,346	9,436	.4606	7.8
Royal Dutch Pete Co	102,815	223,714	.4596	4.3
AMF Inc	25,587	55,968	.4572	−4.7
Tropicana Products Inc	8,424	18,579	.4534	−6.5
A Sted Industries Inc	8,621	20,295	.4248	−2.9
Reeves Bros. Inc	1,211	2,854	.4245	1.2
American Petrofina Inc	1,500	3,557	.4216	2.6
Bell Telephone Co. of Canada—Bell Canada	8,593	20,498	.4192	−1.6
Anderson Clayton & Co	3,665	9,389	.3903	2.1
Martin Marietta Corp	11,551	29,783	.3878	−8.3
Whiting Corp	1,201	3,143	.3821	16.3
United States Shoe Corp	5,715	15,620	.3659	−9.2
Houghton Mifflin Co	1,072	2,947	.3637	6.0
Square D Co	6,095	16,774	.3634	−3.1
Grace, W. R. & Co	21,315	59,109	.3606	−2.6
Alco Standard Corp	3,138	8,863	.3541	13.4
Smiths Transfer, Staunton, Va	756	2,136	.3540	−.7
Southern Railway Co	14,400	43,413	.3317	−6.5
General Tire & Rubber Co	11,925	36,215	.3293	3.0
Hobart Corp	2,414	7,402	.3262	−16.2
Ashland Oil Inc	20,657	64,365	.3209	−5.8
Ogden Corp	7,319	23,06[illegible]	.3173	25.8
United States Gypsum Co	10,601	34,541	.3069	−7.1
Airborne Freight Corp	1,605	5,414	.2965	−4.3
Midland Ross Corp	3,978	13,441	.2959	2.6
Earhart Corp., Virginia	5,856	19,795	.2958	6.5
Stepan Chemical Co	302	1,025	.2947	13.8
McGraw Hill Inc	10,216	34,850	.2931	3.0
Republic Steel Corp	8,457	29,195	.2897	.4
FMC Corp	17,973	62,226	.2888	3.6
Borg Warner Corp	7,081	24,643	.2874	2.9
United Industrial Corp	895	3,154	.2839	10.0
McLean Trucking Co	883	3,117	.2832	19.1
Ryder Systems Inc	6,342	22,594	.2807	−5.2
Colles Communications Inc	2,207	8,030	.2748	7.0
Great Northern Nekoosa Corp	5,877	21,413	.2745	−9.2
Cramer Electronics Inc	112	411	.2728	19.1
National Services Industries Inc	1,951	7,173	.2719	−5.8
General Medicine Corp	1,659	6,125	.2709	6.4
Leaseway Transactions Corp	2,689	10,240	.2626	−10.7
ACF Industries Inc	3,526	13,527	.2607	−1.8
Reynolds Securities International Inc	491	1,893	.2596	−17.6
Esmark Inc	8,881	34,365	.2584	−15.4

TOP 88 SALES RELATIVE TO VOLUME—Continued

[139 banks, $123,000,000,000 in common stock holdings, Mar. 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/volume	Quarter price change
Allied Products Corp., Delaware	$243	$943	0.2580	−3.5
Pitney Bowes, Inc	11,593	46,621	.2487	15.1
Public Service Co., New Mexico	2,127	8,677	.2452	−10.4
Thiokol Corp	4,641	18,951	.2449	3.9
Great Lakes Chemical Corp., Delaware	2,259	9,425	.2397	6.2
Colt Industries, Inc	8,432	35,435	.2380	−9.2
American Air Filter Inc	2,696	11,398	.2366	12.0
Gardner Denver Co	5,056	21,584	.2342	11.4
American General Insurance Co	6,622	28,396	.2332	−9.9
Sundstrand Corp	2,679	11,692	.2291	−.7
Florida Gas Co	3,408	15,355	.2220	9.6
Texas Eastern Corp	16,753	75,573	.2217	.6
James, Fred S. & Co., Inc	1,011	4,616	.2191	−.3
Grainger, W. W., Inc	2,199	10,096	.2178	−5.4
Chromalloy American Corp	1,703	8,062	.2112	9.2
Thomas Industries Inc	280	1,328	.2110	−18.6
Kidde, Walter & Co., Inc	1,987	9,510	.2090	−6.1
Cities Service Co	30,591	146,511	.2088	−.6
Air Products & Chemicals, Inc	13,287	65,116	.2040	−20.3
Eaton Corp	4,977	24,646	.2020	−3.7
Copeland Corp	1,029	5,110	.2015	−7.8
American Stores Co	1,262	6,277	.2010	−3.1
Woolworth, F. W. Co	15,456	77,143	.2004	−1.0
Chesebrough Ponds Inc	9,448	47,279	.1998	−12.0
Westvaco Corp	4,506	22,660	.1988	1.2
Pet Inc	1,523	7,687	.1981	−1.6
PPG Industries, Inc	13,753	69,836	.1969	−6.3
Panhandle Eastern Pipe Line Co	13,310	67,603	.1969	−10.7
Trans Union Corp	2,471	12,653	.1953	1.4
Pneumo Corp	2,209	11,357	.1945	4.7
Transway International Corp	1,577	8,190	.1926	−8.6
General Signal Corp	4,121	21,402	.1926	−2.6
Parker Hannifin Corp	1,290	6,704	.1925	6.6
Capital Holding Corp., Delaware	5,183	26,975	.1922	−6.2
Engelhard Minerals & Chemicals	7,630	40,001	.1907	8.6
Huyck Corp	1,465	7,792	.1881	.9
Bell & Howell Co	1,515	8,075	.1876	2.7

Grand squared deviations	105921.02103113
Squared deviations between classes	3644.52731460
Squared deviations within classes	102276.49371678
Number of classes	10(N1=9 D.F.)
Number of observations	882(N2=872 D.F.)
F=(SDBC/N1)/(SDWC/N2) equals	3.453

	Count	Transactions/volume average	Quarter price change: Average	Quarter price change: Standard deviation
Class:				
1	88	−0.1665	−8.0840	12.0959
2	88	−.0662	−7.1226	9.4119
3	89	−.0294	−4.4769	12.3876
4	88	−.0113	−5.8792	9.7382
5	88	.0003	−4.0320	12.5538
6	88	.0146	−4.8278	9.6524
7	88	.0378	−4.7326	11.0003
8	89	.0729	−5.0928	11.0314
9	88	.1307	−3.3801	9.7418
10	88	.3043	−.1880	9.3572
Total	882	.0287	−4.7816	10.9586

TOP 88 SALES RELATIVE TO VOLUME—Continued

[139 banks, $123,000,000,000 in common stock holdings, March 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/ volume	May price change
Houdaille Industries Inc	−$3,035	$7,830	−0.3876	7.3
Matsushita Electronic Industrial Ltd	−3,553	9,775	−.3634	−.5
Allright Auto Pks. Inc	−399	1,148	−.3480	1.4
CRS Design Association Inc	−329	954	−.3451	−1.8
Mercantile Stores Inc	−3,069	9,252	−.3317	−9.4
Hotel Investors	−379	1,233	−.3071	1.0
Edison Bros. Stores Inc	−1,550	5,051	−.3069	−10.5
VF Corp	−1,544	5,811	−.2658	−5.1
Sony Corp	−33,311	125,689	−.2650	−7.6
Harvey Group Inc	−30	118	−.2515	12.5
Marriott Corp	−15,405	61,843	−.2491	−3.8
Howard Johnson Co	−7,434	31,149	−.2387	−1.3
Marsh & McLennan Cos. Inc	−9,978	42,512	−.2347	1.5
Goodrich, B.F., Co	−8,179	35,305	−.2317	−11.5
Carrier Corp	−8,191	36,680	−.2233	8.9
First Chicago Corp	−6,847	31,133	−.2199	−9.5
Zayre Corp	−915	4,203	−.2177	−10.8
Richardson Merrell Inc	−3,480	16,291	−.2136	−19.8
Inco Ltd	−14,767	70,482	−.2095	−14.5
Alcon Labs Inc	−2,244	10,763	−.2085	−12.8
Cincinnati Milacron Inc	−1,189	5,753	−.2066	−.7
Bearings Inc	−1,229	6,291	−.1953	5.0
Rexmord Inc	−3,242	16,638	−.1948	2.1
Mary Kay Cosmetics Inc	−1,782	9,180	−.1941	−6.7
Peabody International Corp	−4,020	21,008	−.1914	9.4
ASARCO Inc	−13,116	69,772	−.1880	−17.3
Kollmorgan Corp	−340	1,829	−.1859	−3.7
Ennis Business Forms Inc	−122	665	−.1841	−8.2
Chemetron Corp	−1,650	9,036	−.1826	−2.1
Louisville Gas & Electric Co	−1,157	6,571	−.1761	2.0
Illinois Power Co	−4,830	27,583	−.1751	−.5
Lowenstein, M. & Sons Inc	−382	2,198	−.1740	−1.0
Skaggs Cos. Inc	−1,512	8,730	−.1732	5.6
Dow Jones & Co. Inc	−2,327	13,766	−.1691	−.4
Pizza Hut Inc, Delaware	−4,223	25,110	−.1682	37.1
Eckerd, Jack, Corp	−4,289	25,589	−.1676	−6.8
Giddings & Lewis Inc	−956	5,751	−.1663	−4.7
Chane Co	−2,417	15,132	−.1597	2.4
International Flavors & Fragrances	−7,126	44,726	−.1593	−6.7
Goodyear Tire & Rubber Co	−14,551	93,502	−.1556	−3.8
Continental Telephone Corp	−5,075	32,952	−.1540	3.1
Bank VA Co	−660	4,364	−.1512	.9
Pioneer Corp., Texas	−3,262	21,612	−.1509	−1.9
Disney, Walt Productions	−24,433	165,408	−.1477	−7.2
Joy Manufacturing Co	−7,654	52,445	−.1459	−7.7
First International Bancshares Inc	−2,999	20,634	−.1454	6.0
Procter & Gamble Co	−25,794	179,155	−.1440	−6.2
Dr. Pepper Co	−2,712	18,835	−.1440	−3.2
Lubrizol Corp	−6,006	42,969	−.1398	−1.6
Perkin, Elmer, Corp	−3,591	26,225	−.1369	−2.8
Portec Inc	−1,361	9,966	−.1366	25.1
Pacific Lumber Co	−1,394	10,451	−.1334	0
Burns International Security Services, Inc	−398	3,013	−.1322	−11.7
Dun & Bradstreet Cos. Inc	−4,503	34,053	−.1322	−5.0
American Airlines Inc	−4,135	32,840	−.1259	12.2
Black & Decker Manufacturing Co	−6,584	52,293	−.1259	−5.3
Jonathan Logan Inc	−802	6,407	−.1251	−3.8
International Business Machines	−195,176	1,560,372	−.1251	−11.2
Mony Mortgage Investors	−809	6,527	−.1240	0
National Chemsearch Corp	−1,477	12,236	−.1207	−3.1
Ralston Purina Co	−7,645	63,465	−.1205	0
Bank New York Inc	−1,108	9,296	−.1192	−2.0
Hall, Frank B. Co. Inc	−1,005	8,528	−.1178	9.6
Japan FD Inc	−462	3,992	−.1158	−3.0
Delta Air Lines Inc	−6,651	57,462	−.1157	18.3
General Growth Properties	−430	3,725	−.1153	5.6
Buehler Corp	−59	517	−.1140	−20.8
Hilton Hotels Corp	−1,256	11,258	−.1116	6.3
Lane Bryant Inc	−245	2,202	−.1113	9.2
McDonalds Corp	−24,725	228,729	−.1081	1.3
Ferro Corp	−662	6,194	−.1069	−9.2
Medusa Corp	−316	2,966	−.1066	2.6
Knight Ridder Newspapers Inc	−1,118	10,616	−.1053	.4
American Garden Productions	−168	1,627	−.1031	9.8
Zenith Radio Corp	−5,055	49,713	−.1017	−3.6
Illinois Tool Works Inc	−501	4,934	−.1016	5.4
Media General Inc	−327	3,249	−.1008	0
Amstar Corp	−980	9,886	−.0992	−15.3
Transcon Lines	−200	2,047	−.0977	−13.8

TOP 88 SALES RELATIVE TO VOLUME—Continued

[139 banks, $123,000,000,000 in common stock holdings, March 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions volume	May price change
Texas Utilities Co	−$7,903	$81,028	−0.0975	4.5
West Point Pepperell Inc	−1,126	11,625	−.0969	−5.0
Lomas & Nettleton Financial Corp	−694	7,193	−.0965	−7.9
Federated Department Stores Inc	−8,931	93,043	−.0960	−14.6
Cleveland Cliffs Iron Co	−1,052	11,026	−.0954	−4.9
Hoover Ball & Bearing Co	−241	2,555	−.0942	16.1
Monroe Auto Equipment Co	−1,674	17,906	−.0935	14.7
Southland Corp	−1,543	16,586	−.0930	−6.8
Binney & Smith Inc	−169	1,830	−.0922	15.7
MacDonald, E. F., Co	1,165	1,597	.7298	2.1
Kennametal, Inc	4,710	6,759	.6969	3.3
Carlisle Corp	1,548	2,741	.5648	11.1
Bliss & Laughlin Industries, Inc	1,957	3,486	.5613	2.2
Warner & Swasey Co	2,945	5,270	.5588	−6.1
Energy Research Corp	397	811	.4889	4.3
Allegheny Ludlum Industries, Inc	7,854	16,385	.4794	−4.9
Diamond International Corp	6,796	14,309	.4749	−11.6
Ex-Cell-O Corp	4,346	9,436	.4606	0
Royal Dutch Pete Co	102,815	223,714	.4596	3.4
AMF, Inc	25,587	55,968	.4572	−7.4
Tropicana Productions Inc	8,424	18,579	.4534	−9.5
Amsted Industries, Inc	8,621	20,295	.4248	8.2
Reeves Brands, Inc	1,211	2,854	.4245	−3.4
American Petrofina, Inc	1,500	3,557	.4216	0
Bell Telephone Co. of Canada—Bell Canada	8,593	20,498	.4192	4.3
Anderson Clayton & Co	3,665	9,389	.3903	3.1
Martin Marietta Corp	11,551	29,783	.3878	15.3
Whiting Corp	1,201	3,143	.3821	.5
United States Shoe Corp	5,715	15,620	.3659	−18.7
Houghton Mifflin Co	1,072	2,947	.3637	−.7
Square D Co	6,095	16,774	.3634	−3.7
Grace, W. R., & Co	21,315	59,109	.3606	3.5
Alco Standard Corp	3,138	8,863	.3541	4.7
Smiths Transfer, Staunton, Va	756	2,136	.3540	−6.3
Southern Railway Co	14,400	43,413	.3317	1.1
General Tire & Rubber Co	11,925	36,215	.3293	−3.3
Hobart Corp	2,414	7,402	.3262	1.2
Ashland Oil Inc	20,657	64,365	.3209	9.2
Ogden Corp	7,319	23,067	.3173	−.9
United States Gypsum Co	10,601	34,541	.3069	−8.2
Airborne Freight Corp	1,605	5,414	.2965	−14.4
Midland Ross Corp	3,978	13,441	.2959	5.9
Emhart Corp., Virginia	5,856	19,795	.2958	−2.9
Stepan Chemical Co	302	1,025	.2947	11.5
McGraw-Hill, Inc	10,216	34,850	.2931	.7
Republic Steel Corp	8,457	29,195	.2897	−12.9
FMC Corp	17,973	62,226	.2888	1.5
Borg Warner Corp	7,081	24,643	.2874	−9.2
United Industrial Corp	895	3,154	.2839	10.5
McLean Trucking Co	883	3,117	.2832	4.8
Ryder Systems, Inc	6,342	22,594	.2807	4.8
Cowles Communications, Inc	2,207	8,030	.2748	10.3
Great Northern Nekoosa Corp	5,877	21,413	.2745	−4.2
Cramer Electronics, Inc	112	411	.2728	−10.8
National Service Industries, Inc	1,951	7,173	.2719	−.9
General Medicine Corp	1,659	6,125	.2709	−16.1
Leaseway Transactions Corp	2,689	10,240	.2626	22.2
ACF Industries, Inc	3,526	13,527	.2607	5.4
Reynolds Securities Interntional, Inc	491	1,893	.2596	−12.8
Esmark Inc	8,881	34,365	.2584	4.5
Allied Products Corp., Delaware	243	943	.2580	1.2
Pitney Bowes Inc	11,593	46,621	.2487	4.1
Public Service Co., New Mexico	2,127	8,677	.2452	1.2
Thiokol Corp	4,641	18,951	.2449	23.1
Great Lakes Chemical Corp., Delaware	2,259	9,425	.2397	−2.1
Colt Industries, Inc	8,432	35,435	.2380	12.6
American Air Filter, Inc	2,696	11,398	.2366	3.0
Gardner Denver Co	5,056	21,584	.2342	−10.8
American General Insurance Co	6,622	28,396	.2332	0
Sundstrand Corp	2,679	11,692	.2291	4.6
Florida Gas Co	3,408	15,355	.2220	4.9
Texas Eastern Corp	16,753	75,573	.2217	−7.0
James, Fred S., Co., Inc	1,011	4,616	.2191	16.9
Grainger, W. W., Inc	2,199	10,096	.2178	4.4
Chromalloy Amern Corp	1,703	8,062	.2112	−2.3
Thomas Industries, Inc	280	1,328	.2110	9.6
Kidde, Walter, Co., Inc	1,987	9,510	.2090	−8.9
Cities Service Co	30,591	146,511	.2088	−3.5
Air Productions & Chemicals, Inc	13,287	65,116	.2040	−14.6

TOP 88 SALES RELATIVE TO VOLUME—Continued

[139 banks, $123,000,000,000 in common stock holdings, March 31, 1977, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/volume	May price change
Eaton Corp	$4,977	$24,646	0.2020	3.6
Copeland Corp	1,029	5,110	.2015	–.7
American Stores Co	1,262	6,277	.2010	.4
Woolworth, F. W., Co	15,456	77,143	.2004	–13.7
Chesebrough Ponds, Inc	9,448	47,279	.1998	–4.5
Westvaco Corp	4,506	22,660	.1988	–7.5
Pet, Inc	1,523	7,687	.1981	1.6
PPG Industries, Inc	13,753	69,836	.1969	3.0
Panhandle Eastern Pipe Line Co	13,310	67,603	.1969	6.7
Trans UN Corp	2,471	12,653	.1953	–3.4
Pneumo Corp	2,209	11,357	.1945	6.0
Transway International Corp	1,577	8,190	.1926	13.6
General Signal Corp	4,121	21,402	.1926	5.4
Parker Hannifin Corp	1,290	6,704	.1925	12.8
Capital Holdings Corp., Delaware	5,183	26,975	.1922	–4.8
Engelhard Minerals & Chemicals	7,630	40,001	.1907	–13.7
Huyck Corp	1,465	7,792	.1881	–8.3
Bell & Howell Co	1,515	8,075	.1876	3.2

Grand squared deviations	62070.66711652
Squared deviations between classes	484.46208088
Squared deviations within classes	61586.20503570
Number of classes	10(N1=9 D.F.)
Number of observations	882(N2=872 D.F.)
F=(SDBC/N1)/(SDWC/N2) equals	.762

Class:	Count	Transactions/volume average	May price change: Average	May price change: Standard deviation
1	88	–0.1665	–1.0893	9.4308
2	88	–.0662	–1.4427	8.6507
3	89	–.0294	.0915	8.5885
4	88	–.0113	–.4077	7.7152
5	88	.0003	–.2414	8.7406
6	88	.0146	1.0798	7.9124
7	88	.0378	.7304	7.2911
8	89	.0729	.3776	8.0576
9	88	.1307	–.4053	8.6148
10	88	.3043	.3082	8.3607
Total	882	.0287	–.0991	8.3890

TOP 77 SALES RELATIVE TO VOLUME

[129 banks, $127,000,000,000 in common stock holdings, June 30 1976, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/volume	Quarter price change
King Radio Corp	–$1,308	$391	–.33451	–3.9
Wallace Business Forms, Inc	–2,125	3,956	–.5373	–10.9
Genuine Parts Co	–10,262	21,562	–.4759	0
Walker Hiram Gooderham Worts	–1,767	3,781	–.4674	7.
Dillon Cos. Inc	–2,443	5,387	–.4535	–13.
Northwestern Mutual Life Mortgage Realty Investors	–2,551	5,837	–.4370	–8.
Mass Mutual Mortgage Realty Investors	–1,716	4,409	–.3892	–4.
Gamble Skogmo Inc	–2,241	5,889	–.3805	–11.
Ensepch Corp	–7,070	19,388	–.3647	–2.
Echlin Manufacturing Co	–2,803	7,767	–.3608	–9.
Heller, Walter E. International Corp	–4,840	14,265	–.3393	–6.
Lea Royal Inc	–335	1,012	–.3311	–7.
Foster Wheeler Corp	–3,208	10,016	–.3203	25.
Coca Cola Bottling Co., New York	–4,700	15,576	–.3018	1.
Transohio Financial Corp	–525	1,968	–.2669	0.
Schlitz Productions Jos. Brewing Co	–5,249	20,248	–.2592	–6.
Johnson Productions Inc. Delaware	–843	3,258	–.2588	–31.
Louisville Gas & Electric Co	–2,145	8,371	–.2562	1.

TOP 77 SALES RELATIVE TO VOLUME—Continued

[129 banks, $127,000,000,000 in common stock holdings, June 30, 1976, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/volume	Quarter price change
Roper Corp	−$653	$2,559	−0.2552	1.4
Times Mirror Co	−5,678	22,736	−.2497	10.0
Lubizol Corp	−10,279	41,194	−.2495	1.9
Anderson Clayton & Co	−2,126	8,652	−.2457	16.6
Maytag Co	−3,509	14,568	−.2409	−7.9
Malone Hyde Inc	−697	3,094	−.2254	−11.0
Hunt, Philip A., Chemical Corp	−1,078	4,857	−.2219	−17.0
Continental Telephone Corp	−4,702	21,512	−.2186	−5.5
Naste Management Inc	−912	4,192	−.2176	0.
Gifford Hill Co., Inc	−144	664	−.2169	−11.1
Mercantile Stores Inc	−1,309	6,074	−.2156	−23.8
Lomas Nettleton Fine Corp	−1,066	5,053	−.2110	−16.9
Globe UN Inc	−951	4,543	−.2094	11.5
Jonathan Logan Inc	−2,482	11,974	−.2073	−19.7
Knight Ridder Newspapers Inc	−4,531	21,878	−.2071	−7.4
Sony Corp	−15,356	77,882	−.1972	6.8
Louisiana Ld. & Expl. Co	−14,878	75,707	−.1965	12.7
Thrifty Drug Stores Inc	−465	2,390	−.1945	−12.7
Avery International Corp	−1,546	8,079	−.1914	−.5
Marsh McLennan Cos. Inc	−6,017	32,956	−.1826	9.0
Lehigh Portland Cement Co	−344	1,901	−.1809	−.9
American Dist. Teleg. Co	−1,522	8,606	−.1769	−8.5
Dun & Bradstreet Cos. Inc	−5,126	29,064	−.1764	−1.3
Ecodyne Corp	−256	1,465	−.1750	20.6
Gannett Inc., Delaware	−4,052	23,327	−.1737	3.5
Scottys Inc	−245	1,421	−.1724	−16.2
Lee Enterprises Inc	−357	2,089	−.1710	1.6
United Telecommunications	−7,795	45,777	−.1703	−6.3
CTS Corp	−1,023	6,046	−.1693	−2.5
Armstrong Cork Co	−6,265	37,248	−.1682	−19.1
Southern National Research Inc	−4,264	25,454	−.1675	10.1
Revlon Inc	−12,769	77,059	−.1657	11.3
Inland Container Corp	−1,474	9,021	−.1634	.9
Lowenstein M. & Sons Inc	−850	5,203	−.1634	−2.9
Albertsons Inc	−724	4,701	−.1541	7.3
Square D Co	−3,885	25,426	−.1528	5.3
Gatx Corp	−2,498	17,451	−.1431	−12.0
Wisconsin Electric Power Co	−2,363	17,481	−.1352	1.4
Delta Air Lines Inc	−10,546	78,019	−.1352	2.9
Angelica Corp	−469	3,514	−.1336	4.0
Edison Bros. Stores Inc	−635	4,812	−.1318	−11.5
Peabody Galion Corp	−1,657	12,573	−.1318	9.8
Schlumberger Ltd	−27,868	211,703	−.1316	11.2
Media General Inc	−315	2,453	−.1284	−11.9
Airborne Freight Corp	−896	7,117	−.1259	5.4
Collins & Aikman Corp	−969	7,737	−.1252	−14.2
Tidewater Marine Service Inc	−661	5,301	−.1247	4.1
Ahmanson, H. F., & Co	−619	5,234	−.1182	−2.9
Lenox Inc	−837	7,107	−.1178	−5.8
Southeast Brokerage Corp	−679	5,773	−.1177	−4.7
Damon Corp	−884	7,552	−.1171	−10.8
Susquehanna Corp	−43	369	−.1155	6.5
Richardson Merrell Inc	−1,946	16,978	−.1146	−5.0
Parker Drilling Co	−1,958	17,167	−.1140	20.2
UGI Corp	−159	1,404	−.1131	−.8
Emery Air Freight Corp	−3,071	27,172	−.1130	4.7
Louisiana Pac Corp	−2,244	20,407	−.1100	−18.9
Pickwick International Inc	−573	5,226	−.1096	−14.3
Sun Inc	−1,742	16,791	−.1037	21.9
Bliss & Laughlin Industries Inc	1,006	1,091	.9229	−3.1
Castle, A. M., & Co	633	817	.7754	6.9
Cincinnati Milacron Inc	6,048	7,805	7749	16.2
Wallace Murray Corp	2,934	3,931	.7464	−2.7
Warner & Swasey Co	2,688	4,045	.6645	.4
Giddings & Lewis Inc	3,609	5,618	.6425	−6.3
Parker Hannifin Corp	8,753	15,447	.5666	15.1
DuPont, E. I. de Nemours & Co	148,926	264,227	.5636	−4.5
Leigh Productions Inc	121	220	.5508	−14.3
McLean Trucking Co	5,294	10,583	.5002	7.9
Southern Ry. Co	28,076	59,568	.4713	6.5
Alco Standard Corp	2,009	4,663	.4308	.7
Timken Co	9,107	22,152	.4111	17.3
Norton Co	1,854	4,523	.4100	2.5
Proler International Corp	3,388	8,279	.4093	4.3
Foote Cone Belding Communications	237	589	.4017	0
Burndy Corp	2,728	6,922	.3941	4.1
Interlake Inc	3,877	10,350	.3746	1.3
American Finance System Inc	245	671	.3654	−11.5
Eagles Picher Industries Inc	1,487	4,304	.3456	1.1
Witco Chemicals Corp	3,234	9,459	.3419	−4.6
Tektronix Inc	10,878	32,443	.3353	6.7
Jorgensen, Earle M., Co., Delaware	1,850	5,632	.3285	3.5

TOP 77 SALES RELATIVE TO VOLUME—Continued

[129 banks, $127,000,000,000 in common stock holdings, June 30, 1976, quarter]

Name	Bank transactions (thousands)	Market volume (thousands)	Transactions/volume	Quarter price change
Chemical New York Corp	$12,119	$37,151	0.3262	7.9
May Department Stores Co	17,427	53,598	.3252	−13.7
Allied Products Corp., Delaware	346	1,083	.3197	1.0
Sundstrand Corp	12,252	39,160	.3129	22.0
Carter Hawley Hale Stores	6,332	20,781	.3047	−18.2
FMC Corp	12,003	41,069	.2923	−.5
Ex Cell O Corp	2,355	8,073	.2918	4.4
Olinkraft Inc	6,790	23,427	.2898	7.0
Thomas & Betts Corp	3,031	10,496	.2888	8.7
McGraw Edison Co	4,365	15,544	.2808	12.4
Inland Steel Co	22,529	81,213	.2774	11.4
AmFac Inc	1,127	4,076	.2764	−11.6
Continental Oil Co	62,845	234,159	.2684	12.9
National Starch & Chemical Corp	3,006	11,255	.2671	1.7
Borg Warner Corp	6,864	26,016	.2638	−3.5
Trane Co	1,741	6,662	.2613	3.9
Arzona Inc	1,472	5,685	.2589	−13.7
Houghton Mifflin Co	669	2,596	.2576	−4.5
Minnesota Mining and Manufacturing Co	68,179	266,577	.2558	−13.3
VSI Corp	539	2,223	.2470	23.4
UAL Inc	20,137	82,944	.2428	16.8
Tucson Gas & Electric Co	2,108	8,908	.2366	−5.9
Matsushita Electronics Industrial Ltd	3,908	16,747	.2334	11.9
Portec Inc	1,216	5,442	.2235	11.5
Cessna Aircraft Co	3,821	17,224	.2218	17.8
Newmont Mining Corp	7,559	34,168	.2212	7.2
Hospital Corp., American	4,171	19,076	.2186	6.3
American Standard, Inc	6,787	31,445	.2158	−6.6
Scott Fetzer Co	1,414	6,556	.2158	5.1
Schering Plough Corp	28,276	132,246	.2138	−5.7
Gardner Denver Co	5,249	25,071	.2094	−2.7
St. Louis-San Francisco Ry. Co	1,619	7,915	.2045	20.9
Continental of Illinois Corp	12,541	61,853	.2027	7.8
Beatrice Foods Co	19,355	96,107	.2014	12.2
Kaiser Aluminum Chemical Corp	5,638	28,219	.1998	15.2
Cominco, Ltd	537	2,704	.1986	2.6
Copperweld Corp	541	2,745	.1970	7.8
Fischbach & Moore, Inc	705	3,582	.1968	−2.4
Bethlehem Steel Corp	21,492	109,267	.1967	8.0
Burroughs Corp	60,207	311,479	.1933	1.2
General Electric Co	59,178	306,324	.1932	8.8
Raytheon Co	14,875	77,316	.1924	14.4
Teradyne, Inc	798	4,186	.1905	15.9
Outboard Marine Corp	3,378	17,979	.1879	−8.1
Continental Corp	10,773	57,590	.1871	−3.8
Santa Fe Industries, Inc	17,187	92,122	.1866	−3.5
Burlington Northern, Inc	9,837	53,465	.1840	25.6
Republic Steel Corp	5,813	32,028	.1815	10.1
Johnson & Johnson	25,381	140,822	.1802	−6.4
Houdaille Industries, Inc	1,119	6,234	.1795	21.0
Community Pub. Service Co	117	655	.1791	.7
American Airlines, Inc	9,478	53,505	.1771	41.8
Ralston Purina Co	11,727	66,366	.1767	6.4
National Steel Corp	6,951	40,206	.1729	10.5

Grand squared deviations	115165.21872786
Squared deviations between classes	3534.21832224
Squared deviations within classes	111631.00040571
Number of classes	10 (N1=9 D.F.)
Number of observations	770 (N2=760 D.F.)
F=(SOBC/N1)/(SOWC/N2) equals	2.673

	Count	Transactions/Volume average	Quarter price change: Average	Quarter price change: Standard development
Class:				
1	77	−0.2521	−2.0967	10.9217
2	77	−.0659	−.2570	13.5202
3	77	−.0308	−.4107	12.0707
4	77	−.0076	−.6663	12.7731
5	77	.0062	1.0259	12.0708
6	77	.0254	3.5725	12.3611
7	77	.0491	1.1890	10.8673
8	77	.0841	4.2647	12.9854
9	77	.1339	2.1607	11.9370
10	77	.3144	4.5205	10.5408
Total	770	.0257	1.3303	12.2297

(B) Market Impact of Funds' Transactions

March 1977 quarter transaction vs. March quarter stock price change

1. Differences in percent price change between the 10 groups is even more significant (F equals 4.66) than for banks; however:
2. Pattern is confused. Worst price change is recorded by 4th group; best price change is recorded by 8th group.
3. Banks were net buyers; funds were net sellers.
4. Even though funds are ⅓ the size of banks, they transacted in more stocks—but note reporting differences (banks not required to report small trades).
5. At the extremes (group 1 and 10) funds' trades relative to volume are about as large as banks'.
6. Conclusion: definite relationship between trades and performance. Pattern not as systematic as for banks, but most evident when comparing performance of top 4 groups in the aggregate vs. bottom 4 groups in the aggregate.

March 1977 quarter transactions vs. March 31, 1977–May 31, 1977 stock price change

Same as banks: no relationship.

June 1976 quarter transactions vs. June 1976 quarter stock price change

1. Extraordinary significant (F equals 6.78) and systematic relationship. Top sales off 5.6 percent top purchases up 7.0 percent.
2. Both banks and funds net buyers; funds transacted in more stocks.
3. Funds' trades relative to volume are as large as banks.
4. Conclusion: definite relationship between trades and performance. Pattern even more pronounced than for banks.

TOP 117 SALES RELATIVE TO VOLUME

[582 funds, $40,000,000,000 in common stock holdings, Mar. 31, 1977 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
Imperial Chemical Industries, Ltd	−$1,145	$445	−2.5702	5.3
Media General Inc	−2,373	3,249	−.7303	−16.6
Vulcan Materials Co	−5,936	8,562	−.6932	−2.4
Alcolac Inc	−179	274	−.6521	−16.3
Giant Foods, Inc	−754	1,282	−.5878	−6.3
Ethyl Corp	−13,896	26,203	−.5303	−.3
Hobart Corp	−3,127	7,402	−.4225	−16.2
National Silver Industries Inc	−59	142	−.4160	−1.6
Colwell Co	−169	409	−.4136	−13.1
Harsco Corp	−1,553	3,782	−.4107	−2.0
Rochester Telephone Corp	−3,354	8,283	−.4049	−1.6
Timken Co	−8,543	21,237	−.4023	−3.1
Brown Co	−450	1,163	−.3869	−12.2
Akzona Inc	−2,783	7,503	−.3709	8.1
Mary Kay Cosmetics Inc	−3,357	9,180	−.3657	−26.4
Seaboard World Airlines Inc	−863	2,382	−.3621	−17.9
Allegheny Ludlum Industries Inc	−5,917	16,385	−.3611	−6.3
Idaho Power Co	−8,135	22,653	−.3591	−10.0
Brockway Glass Co	−3,904	10,935	−.3570	5.1
Commercial Alliance Corp	−587	1,665	−.3529	11.9
Interco, Inc	−5,864	17,129	−.3423	15.1
Canadian Superior Oil, Ltd	−790	2,315	−.3413	−2.8
Plantronics Inc	−1,999	5,878	−.3401	−9.7
Spartan Food System, Inc	−576	1,706	−.3376	−7.5
Hall, Frank B., & Co., Inc	−2,783	8,528	−.3263	−20.3
Zimmer Homes Corp	−294	904	−.3248	−20.6
Collins Foods International, Inc	−895	2,768	−.3232	1.2
Maremont Corp	−3,905	12,194	−.3202	−3.5
EMI, Ltd	−525	1,652	−.3178	−6.7
Foxboro Co	−5,019	15,904	−.3156	−.5
Crown Cork & Seal, Inc	−6,004	19,111	−.3142	−2.9
Firestone Tire & Rubber Co	−19,809	64,877	−.3053	−15.3
Helene Curtis Industries, Inc	−263	862	−.3046	−12.5
Cities Service Co	−39,765	146,511	−.2714	−.6
Bow Valley Industries, Ltd	−3,269	12,124	−.2696	−21.1
Sperry & Hutchinson Co	−791	2,950	−.2681	.8
Vendo Co	−131	513	−.2558	−4.5
Capital Holding Corp. Delaware	−6,866	26,975	−.2545	−6.2
Raytheon Co	−20,516	81,648	−.2513	−7.2
Standard Brands Paint Co	−3,422	13,701	−.2497	−19.4

TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, Mar. 31, 1977 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
McNeil Corp	−424	1,702	−.2493	−1.1
Leaseway Transportation Corp	−2,547	10,240	−.2487	−10.7
Mobile Homes Industries Inc	−243	993	−.2449	−34.3
Great Northern Nekoosa Corp	−5,197	21,413	−.2427	−9.2
Staley, A. E., Manufacturing Co	−3,015	12,467	−.2418	−8.1
Russ Togs Inc	−1,196	4,963	−.2410	−2.2
Rio Grande Industries Inc	−4,819	20,004	−.2409	28.6
Texas Gas Transmission Corp	−12,114	50,920	−.2379	−11.0
American Natural Resources Co	−9,456	39,751	−.2379	−4.8
Yates Industries, Inc	−758	3,193	−.2375	11.4
Cox Cable Communications, Inc	−792	3,350	−.2363	25.2
Ashland Oil, Inc	−15,067	64,365	−.2341	−5.8
Inland Container Corp	−1,810	7,783	−.2326	−.9
Carlisle Corp	−630	2,741	−.2298	19.0
Tyler Corp	−3,116	13,570	−.2296	1.1
Wometco Enterprises, Inc	−752	3,293	−.2285	−15.7
American Financial Systems, Inc	−130	571	−.2278	−7.1
Cooper Industries, Inc	−5,666	24,912	−.2274	5.0
Flexi Van Corp	−2,824	12,440	−.2270	−5.3
Mohasco Corp	−1,951	8,672	−.2250	−10.6
ICH Realty	−256	1,157	−.2211	−28.8
Central Tel & Utilities Corp	−7,575	34,429	−.2200	−.5
Public Service Co. of Colorado	−4,083	18,805	−.2171	−8.6
Revco, D. S., Inc	−4,750	21,996	−.2159	−20.1
Southern Indiana Gas & Electric Co	−709	3,297	−.2150	−1.8
Fischer and Porter Co	−523	2,444	−.2140	11.7
Ideal Basic Industries, Inc	−5,689	26,644	−.2135	−10.9
Vermont American Corp	−333	1,589	−.2095	−10.3
Flight Safety International, Inc	−1,014	4,914	−.2064	−3.1
Canadian Pacific Ltd	−2,419	11,755	−.2058	−3.7
Conchemco, Inc	−96	468	−.2056	−9.4
Stride Rite Corp	−408	2,024	−.2017	13.9
Crouse Hinds Co	−1,366	6,804	−.2008	2.8
Lykes, Corporation of Delaware	−2,823	14,210	−.1987	−13.2
Gulf & Western Industries, Inc	−18,755	94,672	−.1981	−23.3
Loews Corp	−8,485	42,837	−.1981	−7.3
Mountain Fuel Supply Co	−8,940	45,482	−.1966	−7.9
Northwest Industries Inc	−15,434	79,202	−.1949	13.3
Norfolk & Western Railway Co	−9,117	46,804	−.1948	2.0
Maytag Co	−3,535	18,280	−.1934	−18.3
Northwest Airlines, Inc	−9,572	49,929	−.1917	−23.5
Phelps Dodge Corp	−13,950	73,660	−.1894	−17.6
Gatx Corp	−3,534	18,674	−.1893	−12.1
Franklin Mint Corp	−7,421	39,288	−.1889	−20.8
Sperry Rand Corp	−27,747	147,316	−.1884	−17.3
Boeing Co	−24,719	132,335	−.1868	−2.0
Texasgulf Inc	−5,195	27,978	−.1857	1.3
Republic Steel Corp	−5,405	29,195	−.1851	.4
Ehrenreich Photo Optical, Inc	−230	1,249	−.1842	−14.9
Harte Hanks Newspapers, Inc	−344	1,886	−.1827	−6.6
Duplex Products, Inc	−147	805	−.1824	20.5
Lubrizol Corp	−7,829	42,969	−.1822	−14.6
Host International Inc	−562	3,096	−.1815	−14.0
Purex Corp	−2,715	14,987	−.1812	−4.6
Sherwin Williams Co	−1,731	9,578	−.1807	−15.5
Lenox, Inc	−1,363	7,622	−.1789	−2.7
Union Oil Company of California	−15,425	87,166	−.1770	−6.1
Panhandle Eastern Pipeline Co	−11,961	67,603	−.1769	−10.7
Standard Manufacturing Products Inc	−581	3,294	−.1763	−7.8
Southern Pacific Co	−7,786	44,334	−.1756	−7.0
Dennison Manufacturing Co	−1,026	5,859	−.1750	10.7
McDonnell Douglas Corp	−6,194	35,391	−.1750	−15.8
Morton Norwich Products, Inc., Delaware	−3,584	20,576	−.1742	−9.0
Ryan Homes, Inc	−1,149	6,710	−.1713	−14.5
Kansas Power & Light Co	−1,248	7,332	−.1703	1.9
Champion Home Builders Co	−1,195	7,075	−.1690	−22.6
Jostens, Inc	−1,131	6,739	−.1678	19.7
Burndy Corp	−647	3,878	−.1668	−11.3
Miles Laboratories, Inc	−2,104	12,630	−.1666	3.1
Wyly Corp	−274	1,649	−.1664	−14.3
Public Service Co., Indiana, Inc	−7,252	43,880	−.1653	−12.6
BIC Pen Corp	−388	2,350	−.1651	.9
Entex, Inc. (Washington United Gas)	−2,390	14,646	−.1632	0
Nevada Power Co	−706	4,356	−.1622	−10.0
Long Island Lighting Co	−3,692	22,767	−.1622	4.1
Gino's, Inc	−770	4,778	−.1612	−22.8
Tektronix, Inc	−5,232	32,886	−.1591	−13.5

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TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, Mar. 31, 1977 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
International Couriers Corp	1,620	1,016	1.5951	−10.7
Petrie Stores Corp	6,577	9,350	.7035	−.7
Weis Markets Inc	572	1,121	.5102	1.0
Sysco Corp	484	1,115	.4342	−10.1
Scrivner, Inc	104	244	.4268	2.3
American Business Products, Inc	134	329	.4063	−14.3
Standex International Corp	333	903	.3688	−3.7
Eckerd Jack Corp	9,284	25,589	.3628	−17.7
Financial Federation, Inc	3,765	10,651	.3535	11.0
Roper Corp	1,087	3,233	.3364	−7.4
Domtar Ltd	154	458	.3356	−2.4
Mercantile Stores, Inc	2,834	9,252	.3063	−12.4
Unity Buying Service, Inc	140	460	.3037	0
Great Lakes Chemical Corp, Delaware	2,794	9,425	.2964	6.2
Golden West Financial Corp, Delaware	2,442	8,770	.2784	−.7
Kaneb Services, Inc	6,106	22,297	.2738	29.3
Pepcom Industries, Inc	225	830	.2705	−10.5
National Distillers & Chemical	6,824	25,466	.2680	−.5
Bank New York, Inc	2,487	9,296	.2675	.3
Child World, Inc	221	833	.2655	−21.8
Flintkote Co	2,899	11,037	.2627	−10.2
PNB Mortgage & Realty Investment	335	1,314	.2549	−9.5
General Cinema Corp	1,748	6,998	.2498	−13.6
Oakwood Homes Corp	79	323	.2448	0
Marathon Manufacturing Co	1,435	5,996	.2393	−4.8
First Chicago Corp	7,375	31,133	.2369	−13.7
Kansas Nebraska National Gas, Inc	3,828	16,181	.2365	10.6
Edison Bros., Stores, Inc	1,181	5,051	.2337	−.2
Massmutual Mortgage & Realty Investment	656	2,895	.2275	−7.1
Eason Oil Co	939	4,133	.2273	25.9
Molycorp, Inc	8,140	35,840	.2271	16.0
United Financial Corp. of California	1,631	7,301	.2234	7.3
Narco Scientific Industries, Inc	360	1,619	.2227	2.0
Campbell Taggart, Inc	1,354	6,125	.2211	5.2
Seaboard Allied Milling Corp	34	155	.2179	18.5
United States Tobacco Co	1,903	8,736	.2178	6.8
Johnson Coastlines, Inc	4,934	22,747	.2169	44.1
Southern New England Telephone Co	974	4,612	.2112	−6.1
Allied Maintenance Corp	289	1,378	.2097	8.1
Milton Roy Co	382	1,838	.2080	−9.8
Soo Line Railroad Co	652	3,139	.2077	−.6
Smith's Transfer, Staunton, Va	435	2,136	.2036	−.7
Central Maine Power Co	864	4,252	.2033	−1.5
General Refractories Co	139	687	.2029	−1.6
Bluebird Inc	420	2,089	.2011	−10.6
Gearhart Owen Industries, Inc	2,717	13,848	.1962	11.8
Chemical New York Corp	10,300	53,067	.1941	−5.8
Varian Associates, Inc	7,604	40,594	.1873	11.7
Anderson Clayton & Co	1,752	9,389	.1866	2.1
Cowles Communications, Inc	1,471	8,030	.1832	7.0
Del Monte Corp	2,710	14,973	.1810	4.6
Stanley Works	1,183	6,548	.1806	−3.5
Nashua Corp	1,126	6,439	.1748	−7.6
Wood Industry Inc	13	78	.1725	−15.6
Champion International Corp	10,582	61,363	.1724	−13.2
Gannett Inc. Delaware	4,151	24,154	.1719	−15.2
United Merchants & Manufacturers, Inc	1,141	6,662	.1713	−9.8
Lone Star Industrial, Inc	3,183	18,723	.1700	−6.2
NCR Corp	20,420	120,489	.1695	−3.3
Salant Corp	142	842	.1693	1.7
Foremost McKesson, Inc	1,444	8,592	.1681	−3.2
INA Corp	8,585	51,751	.1659	−13.2
Campbell Soup Co	4,175	25,285	.1651	−5.1
Harland, John H. Co	566	3,468	.1632	3.4
Republic Texas Corp	1,845	11,575	.1594	−2.6
Vornado Inc	210	1,324	.1586	−8.7
CTS Corp	1,135	7,333	.1548	.6
Northwestern Steel & Wire Co	910	5,917	.1538	−10.0
Heller Walter E., International Corp	1,471	9,778	.1505	−20.6
Stone & Webster Inc	1,873	12,747	.1469	−4.4
Hart Schaffner & Marx	1,159	8,009	.1447	2.0
Potomac Electric Power Co	3,835	26,717	.1436	4.3
Saga Corp	596	4,163	.1432	−8.2
Gerber Products Co	1,528	10,721	.1426	22.8
Quaker State Oil Refining Corp	3,482	24,461	.1424	−7.0
Longs Drug Stores Inc	1,323	9,401	.1408	−21.4
Handy & Harman	360	2,579	.1398	9.9

TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, Mar. 31, 1977 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
Ahmanson, F. E. & Co	1,254	9,027	.1389	11.5
Lomas & Nettleton Mortgage Investments	775	5,630	.1377	3.3
Alcan Aluminum Limited	8,813	64,702	.1362	12.7
Chase Manhattan Corp	15,027	111,078	.1353	−2.4
Cole National Corp	198	1,462	.1352	−2.1
Fleming Cosmetic Inc	429	3,181	.1348	1.5
Braun, C. F. & Co	3,384	25,321	.1336	−8.1
Alexanders Inc	331	2,508	.1321	−12.3
Winn Dixie Stores, Inc., Co	2,536	19,624	.1292	−8.5
Flying Diamond Oil Corp	3,045	23,871	.1275	10.9
AMP Inc	7,201	56,651	.1271	−8.4
U.S. Life Corp	4,003	31,598	.1267	−12.5
Ford Motor Co., Canada, Ltd	82	645	.1264	−2.8
Neptune International Corp	525	4,165	.1260	21.6
City Investing Co	5,118	40,636	.1259	2.8
Purolator, Inc	1,263	10,163	.1243	−27.8
Oklahoma Natural Gas Co	3,438	27,773	.1238	8.3
Maryland Cup Corp	483	3,923	.1230	−10.9
Florida Gas Co	1,885	15,355	.1228	9.6
Magic Chef Inc	1,374	11,385	.1207	−5.1
Keystone Construction Industry, Inc	127	1,065	.1190	−13.0
Pillsbury Co	6,563	55,147	.1190	−12.5
Hayes Albion Corp	236	1,989	.1186	−2.9
Adobe Oil & Gas Corp	1,113	9,425	.1181	.9
Morgan, J. P. & Co. Inc	11,206	95,086	.1179	−10.2
Federal Co	338	2,872	.1177	6.1
Crutcher Research Corp	1,696	14,481	.1171	0
Allis Chalmers Corp	5,486	46,937	.1169	9.6
Pargas, Inc	1,787	15,359	.1164	11.2
Getty Oil Co	11,739	101,927	.1152	−6.1
Allied Chemical Corp	13,463	116,959	.1151	5.9
Cleveland Electric Illuminating Co	3,657	32,029	.1142	−5.8
Reynolds Metals Co	8,346	74,059	.1139	−2.8
Kaiser Aluminum & Chemical Corp	3,690	32,659	.1130	−1.7
Rio Algom, Ltd	68	605	.1118	−6.7
National Medecat Enterprises, Inc	815	7,314	.1114	11.5
Lehigh Portland Cement Co	338	3,059	.1104	5.1
IU International Corp	3,161	28,749	.1100	2.1
Tandycrafts, Inc	658	5,986	.1099	−19.0
Pamida, Inc	308	2,802	.1098	−13.2

QUARTER PRICE CHANGE

Grand squared deviations	202051.71150345
Squared deviations between classes	7061.21936831
Squared deviations within classes	194990.49213538
Number of classes	10(N1=9 D.F.)
Number of observations	1,169(N2=1,159 D.F.)
F=(SDBC/N1)/(SDWC/N2)equals	4.663

	Count	Transaction/volume average	Quarter price change average	Quarter price Change standard deviation
Class:				
1	117	−0.2780	−6.2981	11.0105
2	117	−.1248	−6.4549	7.8905
3	117	−.0745	−2.7829	15.2607
4	117	−.0471	−7.3406	11.2392
5	116	−.0264	−2.8868	11.5705
6	117	−.0094	−.9728	16.6347
7	117	.0080	−.7141	14.4347
8	117	.0326	−.3250	14.6194
9	117	.0758	−2.7217	13.1019
10	117	.2061	−1.4366	10.9858
Total	1,169	−.0238	−3.1936	13.1469

TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, March 31, 1977 Quarter]

Name	Fund transaction (thousands)	Market volume (thousands)	Transaction/volume	May price change
Imperial Chemical Industries, Ltd	−$1,145	$445	−2.5072	5.0
Media Gen., Inc	−2,373	3,249	−.7303	0
Vulcan Materials., Co	−5,936	8,562	−.6932	−16.4
Alcolac, Inc	−179	274	−.6521	−3.5
Giant Foods, Inc	−754	1,282	−.5878	4.5
Ethyl Corp	−13,896	26,203	−.5303	−.9
Hobart Corp	−3,127	7,402	−.4225	1.2
National Silver industries, Inc	−59	142	−.4160	14.7
Colwell Co	−169	409	−.4136	3.8
Harsco Corp	−1,553	3,782	−.4107	8.5
Rochester Telephone., Corp	−3,354	8,283	−.4049	−1.6
Timken Co	−8,543	21,237	−.4023	2.9
Brown Co	−450	1,163	−.3869	−2.8
Akzona, Inc	−2,783	7,503	−.3709	−8.2
Mary Kay Cosmetics, Inc	−3,357	9,180	−.3657	−6.7
Seaboard World Airlines, Inc	−863	2,382	−.3621	13.0
Allegheny Ludlum Industries, Inc	−5,917	16,385	−.3611	−4.9
Idaho Power., Co	−8,135	22,653	−.3591	3.3
Brockway Glass Co	−3,904	10,935	−.3570	−8.4
Commercial Alliance Corp	−587	1,665	−.3529	−3.2
Interco, Inc	−5,864	17,129	−.3423	.6
Canadian Superior Oil, Ltd	−790	2,315	−.3413	9.5
Plantronics, Inc	−1,999	5,878	−.3401	3.4
Spartan Food System, Inc	−576	1,706	−.3376	24.0
Hall Frank B. & Co., Inc	−2,783	8,528	−.3263	9.6
Zimmer Homes Corp	−294	904	−.3248	−6.4
Collins Foods International, Inc	−895	2,768	−.3232	−3.2
Maremont Corp	−3,905	12,194	−.3202	−2.2
EMI, Ltd	−525	1,652	−.3178	7.1
Foxporo Co	−5,019	15,904	−.3156	2.0
Crown Cork & Seal, Inc	−6,004	19,111	−.3142	4.8
Firestone Tire & Rubber Co	−19,809	64,877	−.3053	−6.8
Helene Curtis Industries, Inc	−263	862	−.3046	19.0
Cities Service Co	−39,765	146,511	−.2714	−3.6
Bow Valley Industries Ltd	−3,269	12,124	−.2696	4.3
Sperry & Hutchinson Co	−791	2,950	−.2681	9.6
Vendo Co	−131	513	−.2558	−7.1
Capital HLDG., Corp., Delaware	−6,866	26,975	−.2545	−4.8
Raytheon Co	−20,516	81,648	−.2513	13.1
Standard Brands Paint Co	−3,422	13,701	−.2497	−10.6
McNeil Corp	424	1,702	−.2493	−5.4
Leaseway Transn., Corp	−2,547	10,240	−.2487	22.2
Mobile Homes Industries Inc	−243	993	−.2449	−13.0
Great Northern Nekoosa Corp	−5,197	21,413	−.2427	−4.2
Staley, A. E., Manufacturing Co	−3,015	12,467	−.2418	−10.1
Russ Togs Inc	−1,196	4,963	−.2410	−3.4
Rio Grande Industries, Inc	−4,819	20,004	−.2409	2.8
Texas Gas Transmission Corp	−12,114	50,920	−.2379	5.3
American National Res., Co	−9,456	39,751	−.2379	4.2
Yates Industries, Inc	−758	3,193	−.2375	−4.1
Cox Cable Communications, Inc	−792	3,350	−.2363	2.3
Ashland Oil, Inc	−15,067	64,365	−.2341	9.2
Inland Container Corp	−1,810	7,783	−.2326	−.4
Carlisle Corp	−630	2,741	−.2298	11.1
Tyler Corp	−3,116	13,570	−.2296	−13.0
Wometco Enterprises, Inc	−752	3,293	−.2285	−2.3
American Financial Systems, Inc	−130	571	−.2278	−3.8
Cooper Industries, Inc	−5,666	24,912	−.2274	−1.8
Flexi Van Corp	−2,824	12,440	−.2270	25.6
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ICM Realty	−256	1,157	−.2211	13.5
Central Telephone & Utilities Corp	−7,575	34,429	−.2200	4.0
Public Service Co., Colorado	−4,083	18,805	−.2171	6.5
Revco, D. S., Inc	−4,750	21,996	−.2159	−26.3
Southern Indiana Gas & Electric Co	−709	3,297	−.2150	−5.6
Fischer & Porter Co	−523	2,444	−.2140	2.6
Ideal Basic Industries, Inc	−5,689	26,644	−.2135	3.1
Vermont American Corp	−333	1,589	−.2095	−11.3
Flight Safety International, Inc	−1,014	4,914	−.2064	−1.1
Canadian Pacific, Ltd	−2,419	11,755	−.2058	5.4
Conchemco, Inc	−96	468	−.2056	6.5
Stride Rite Corp	−408	2,024	−.2017	−2.6
Crouse Hinds Co	−1,366	6,804	−.2008	−8.3
Lykes Corp., Delaware	−2,823	14,210	−.1987	−18.5
Gulf & Western Industries, Inc	−18,755	94,672	−.1981	−4.5
Loew's Corp	−8,485	42,837	−.1981	−7.1
Mountain Fuel Supply Co	−8,940	45,482	−.1966	.6
Northwest Industries, Inc	−15,434	79,202	−.1949	6.7
Norfolk & Western Railway Co	−9,117	46,804	−.1948	−4.3
Maytag Co	−3,535	18,280	−.1934	1.7

TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, March 31, 1977 quarter]

Name	Fund transaction (thousands)	Market volume (thousands)	Transaction/volume	May price change
Northwest Airlines, Inc	−$9,572	$49,929	−0.1917	15.4
Phelps Dodge Corp	−13,950	73,660	−.1894	−11.0
Gatx Corp	−3,534	18,674	−.1893	−3.8
Franklin Mint Corp	−7.421	39,288	−.1889	−41.0
Sperry Rand Corp	−27,747	147,316	−.1884	−2.8
Boeing Co	−24,719	132,335	−.1868	15.4
Texasgulf, Inc	−5,195	27,978	−.1857	−14.0
Republic Steel Corp	−5,405	29,195	−.1851	−12.9
Ehrenreich Photo Optical, Inc	−230	1,249	−.1842	−2.5
Harte Hanks Newspapers, Inc	−344	1,886	−.1827	−1.9
Duplex Products, Inc	−147	805	−.1824	−3.7
Lubrizol Corp	−7,829	42,969	−.1822	−1.6
Host International, Inc	−562	3,096	−.1815	3.8
Purex Corp	−2,715	14,987	−.1812	−6.9
Sherwin Williams Co	−1,731	9,578	−.1807	−5.8
Lenox, Inc	−1,363	7,622	−.1789	−3.8
Union Oil Co., California	−15,425	87,166	−.1770	−8.8
Panhandle Eastern Pipeline Co	−11,961	67,603	−.1769	6.7
Standard Motor Products, Inc	−581	3,294	−.1763	6.7
Southern Pacific Co	−7,786	44,334	−.1756	7.1
Dennison Manufacturing Co	−1,026	5,859	−.1750	1.9
McDonnell Douglas Corp	−6,194	35,391	−.1750	13.8
Morton Norwich Products Inc., Delaware	−3,584	20,576	−.1742	11.9
Ryan Homes, Inc	−1,149	6,710	−.1713	−8.8
Kansas Power & Light Co	−1,248	7,332	−.1703	1.2
Champion Home Builders Co	−1,995	7,075	−.1690	−20.8
Jostens, Inc	−1,131	6,739	−.1678	−1.1
Burndy Corp	−647	3,878	−.1668	9.7
Miles Laboratories, Inc	−2,104	12,630	−.1666	−6.6
Wyly Corp	−274	1,649	−.1664	8.3
Public Service Co. of Indiana, Inc	−7,252	43,880	−.1653	1.8
Bic Pen Corp	−388	2,350	−.1651	−14.0
Entex Inc. (was United Gas)	−2,390	14,646	−.1632	11.3
Nevada Power Co	−706	4,356	−.1622	.6
Long Island Lighting Co	−3,692	22,767	−.1622	−1.3
Gino's, Inc	−770	4,778	−.1612	−8.2
Tektronix, Inc	−5,232	32,886	−.1591	13.9
International Couriers Corp	1,620	1,016	1.5951	−1.0
Petrie Stores Corp	6,577	9,350	.7035	−5.7
Weis Markets, Inc	572	1,121	.5102	3.9
Sysco Corp	484	1,115	.4342	16.4
Scrivner, Inc	104	244	.4268	−13.0
American Business Products, Inc	134	329	.4063	.9
Standex International Corp	333	903	.3688	7.7
Eckerd Jack Corp	9,284	25,589	.3628	−6.8
Financial Federation, Inc	3,765	10,651	.3535	5.6
Roper Corp	1,087	3,233	.3364	20.1
Domtar, Ltd	154	458	.3356	−12.6
Mercantile Stores, Inc	2,834	9,252	.3063	−9.4
Unity Buying Service—Inc	140	460	.3037	−20.8
Great Lakes Chemical Corp, Delaware	2,794	9,425	.2964	−2.1
Golden West Financial Corp., Delaware	2,442	8,770	.2784	−7.4
Kaneb Services, Inc	6,106	22,297	.2738	−2.4
Pepcom Industries, Inc	225	830	.2705	10.9
National Distillers & Chemical	6,824	25,466	.2680	−4.5
Bank New York, Inc	2,487	9,296	.2675	−2.0
Child World, Inc	221	833	.2655	−11.4
Flintkote Co	2,899	11,037	.2627	−11.4
PNB Mortgage & Realty Investment	335	1,314	.2549	−7.5
General Cinema Corp	1,748	6,998	.2498	−7.6
Oakwood Homes Corp	79	323	.2448	1.3
Marathon Manufacturing Co	1,435	5,996	.2393	29.0
First Chicago Corp	7,375	31,133	.2369	−9.5
Kansas-Nebraska Natural Gas, Inc	3,828	16,181	.2365	9.6
Edison Bros., Stores, Inc	1,181	5,051	.2337	−10.5
Massmutual Mortgage & Realty Investment	656	2,885	.2275	4.8
Eason Oil Co	939	4,133	.2273	41.3
Molycorp, Inc	8,140	35,840	.2271	10.5
United Financial Corp., California	1,631	7,301	.2234	13.6
NARCO Scientific Industries, Inc	360	1,619	.2227	−8.7
Campbell Taggart, Inc	1,354	6,125	.2211	5.2
Seaboard Allied Manufacturing Corp	34	155	.2179	1.3
United States Tobacco Co	1,903	8,736	.2178	9.1
Johnson Ctls. Inc	4,934	22,747	.2169	21.4
Southern New England Telephone Co	974	4,612	.2112	1.0
Allied Maintenance Corp	289	1,378	.2097	−3.7
Milton Roy Co	382	1,838	.2080	−5.5
Soo Line Railroad Co	652	3,139	.2077	21.4
Smiths Transfer, Staunton, Virginia	435	2,136	.2036	−6.3
Central Maine Power Co	864	4,252	.2033	0

TOP 117 SALES RELATIVE TO VOLUME—Continued

[582 funds, $40,000,000,000 in common stock holdings, March 31, 1977 quarter]

Name	Fund transaction (thousands)	Market volume (thousands)	Transaction/ volume	May price change
General Refractories Co	$139	$687	0.2029	19.4
Bluebird, Inc	420	2,089	.2011	.0
Gearhart Owen Industries, Inc	2,717	13,848	.1962	18.7
Chemical New York Corp	10,300	53,067	.1941	10.2
Varian Association, Inc	7,604	40,594	.1873	11.2
Anderson, Clayton & Co	1,752	9,389	.1866	3.1
Cowles Communications, Inc	1,471	8,030	.1832	10.3
Del Monte Corp	2,710	14,973	.1810	−8.3
Stanley Works	1,183	6,548	.1806	6.4
Nashua Corp	1,126	6,439	.1748	17.3
Wood Industries, Inc	13	78	.1725	14.8
Champion International Corp	10,582	61,363	.1724	−5.8
Gannett, Inc, Delaware	4,151	24,154	.1719	−3.6
United Merchants & Manufacturers, Inc	1,141	6,662	.1713	−34.9
Lone Star Industries, Inc	3,183	18,723	.1700	.6
NOR Corp	20,420	120,489	.1695	−5.9
Salant Corp	142	842	.1693	−5.3
Foremost McKesson, Inc	1,444	8,592	.1681	0
INA Corp	8,585	51,751	.1659	10.1
Campbell Soup Co	4,175	25,285	.1651	.3
Harland, John H., Co	566	3,468	.1632	8.4
Republic Textile Corp	1,845	11,575	.1594	−2.3
Vornado, Inc	210	1,324	.1586	−7.1
CTS Corp	1,135	7,333	.1548	1.9
Northwestern Steel & Wire Co	910	5,917	.1538	−3.7
Heller Walter E., International Corp	1,471	9,778	.1505	5.6
Stone & Webster, Inc	1,873	12,747	.1469	12.1
Hart Schaffner & Marx	1,159	8,009	.1447	−6.8
Potomac Electric Power Co	3,835	26,717	.1436	0
Saga Corp	596	4,163	.1432	−8.9
Gerber Products Co	1,528	10,721	.1426	19.4
Quaker State Oil Refining Corp	3,482	24,461	.1424	−15.6
Longs Drug Stores, Inc	1,323	9,401	.1408	−12.2
Handy & Hapman	360	2,579	.1398	−1.7
Ahmanson, H. F. & Co	1,254	9,027	.1389	−7.5
Lomas & Nettleton Marketing Investors	775	5,630	.1377	5.6
Alcan Aluminium Ltd	8,813	64,702	.1362	3.3
Chase Manhattan Corp	15,027	111,078	.1353	5.0
Cole National Corp	198	1,462	.1352	−12.9
Fleming Cos, Inc	429	3,181	.1348	−5.3
Braun, C. F. & Co	3,384	25,321	.1336	1.8
Alexanders, Inc	331	2,508	.1321	−4.0
Winn Dixie Stores, Inc. Com	2,536	19,624	.1292	2.4
Flying Diamond Oil Corp	3,045	23,871	.1275	−12.0
AMP, Inc	7,201	56,651	.1271	1.4
U.S. Life Corp	4,003	31,598	.1267	9.2
Ford Motor Company Canada Ltd	82	645	.1264	.9
Neptune International Corp	525	4,165	.1260	0
City Investing Co	5,118	40,636	.1259	6.4
Purolator, Inc	1,263	10,163	.1243	−2.4
Oklahoma National Gas Co	3,438	27,773	.1238	−7.0
Maryland Cup Corp	483	3,923	.1230	−3.5
Florida Gas Co	1,885	15,355	.1228	4.9
Magic Chef, Inc	1,374	11,385	.1207	2.7
Keystone Construction Inds, Inc	127	1,065	.1190	−11.6
Pillsbury Co	6,563	55,147	.1190	−1.4
Hayes Albion Corp	236	1,989	.1186	3.8
Adobe Oil & Gas Corp	1,113	9,425	.1181	0
Morgan, J. P. & Co., Inc	11,206	95,086	.1179	−4.2
Federal Co	338	2,872	.1177	−1.0
Crutcher Research Corp	1,696	14,481	.1171	−7.4
Allis Chalmers Corp	5,486	46,937	.1169	9.6
Pargas, Inc	1,787	15,359	.1164	−2.1
Getty Oil Co	11,739	101,927	.1152	−.7
Allied Chemical Corp	13,463	116,959	.1151	10.3
Cleveland Electric Illuminating Co	3,657	32,029	.1142	1.1
Reynolds Metals Co	8,436	74,059	.1139	2.3
Kaiser Aluminum & Chemical Corp	3,690	32,659	.1130	−2.8
Rio Algom, Ltd	68	605	.1118	3.8
National Medical Enterprises, Inc	815	7,314	.1114	6.2
Lehigh Portland Cement Co	338	3,059	.1104	−.7
IU International Corp	3,161	28,749	.1100	2.1
Tandycrafts, Inc	658	5,986	.1099	1.[illegible]
Pamida, Inc	308	2,802	.1098	−3.0

MAY RICE CHANGE

Grand squared deviations	110566.30385755
Squared deviations between classes	797.56086448
Squared deviations with classes	109768.74299319
Number of c'asses	10 (N1=9DF)
Number of observations	1,169 (N2=1,159DF)
F=(SDAG/N1)/(SDWC/N2) equal	.936

	Count	Transaction/volume average	May price change average	May price change standard deviation
Class:				
1	117	−0.2780	−0.1645	9.8507
2	117	−.1248	−1.2268	8.1065
3	117	−.0745	.5272	10.3336
4	117	−.0471	.0307	9.3044
5	116	−.0264	.6992	9.4551
6	117	−.0094	−.1376	10.2613
7	117	.0080	.1374	8.5779
8	117	.0326	.3917	11.4759
9	117	.0758	2.1416	8.9064
10	117	.2061	.9162	10.1764
Total	1,169	−.0238	.3312	9.7253

TOP 104 SALES RELATIVE TO VOLUME

[378 funds, $44,000,000,000 in common stock holdings, June 30, 1976 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
Colonial Coal Corp	−$302	$190	−1.5869	−6.9
Placer Developer, Ltd	−709	528	−1.3417	−2.6
Oriole Homes Corp	−156	125	−1.2552	−22.2
National Kinney Corp	−605	620	−.9766	−11.8
International Couriers Corp	−2,111	2,468	−.8554	−30.5
Vulcan Materials Co	−7,445	9,299	−.8006	−2.7
Tonka Corp	−1,489	1,928	−.7723	−10.9
Elgin National Industries, Inc	−1,681	2,338	−.7022	10.2
Hospital Mortgage Group	−461	693	−.6646	−21.7
Lenox, Inc	−4,428	7,107	−.6231	−5.8
Eltra Corp	−9,160	15,107	−.6064	6.9
Barber Oil Corp	−2,836	4,871	−.5821	.9
Parker Pen Co, Delaware	−1,916	3,329	−.5755	2.6
Deltona Corp	−1,024	2,065	−.4960	−37.3
Zale Corp	−4,359	9,083	−.4799	−27.3
Stop & Shop, Inc	−1,209	2,552	−.4736	−24.3
Salant Corp	−1,330	2,879	−.4621	−21.7
Kollmorgan Corp	−1,211	2,625	−.4612	21.8
Lloyd, S. Electronics, Inc	−371	808	−.4589	−24.3
Washington Gas Light, Co	−1,020	2,279	−.4475	−1.3
Wolf, Howard B., Inc	−64	144	−.4453	−26.2
Fleetwood Enterprises, Inc	−11,659	26,201	−.4450	−9.6
Tropicana Products, Inc	−18,672	42,452	−.4398	−.9
House Fabrics, Inc	−2,553	6,406	−.3985	−19.6
Soundesign Corp	−1,679	4,268	−.3934	0
Purolator, Inc	−4,873	12,562	−.3879	−32.4
Time, Inc	−15,128	39,078	−.3871	−3.3
Pittway Corp	−2,541	6,573	−.3867	1.0
Cutler Hammer, Inc	−3,032	8,001	−.3790	.6
DPF Inc	−725	1,926	−.3764	7.4
International Rectifier Corp	−230	621	−.3698	−11.1
Crown Zellerbach Corp	−19,547	52,989	−.3689	−2.5
Wallace Business Forms, Inc	−1,423	3,956	−.3598	−10.9
Leslie Fay, Inc	−991	2,761	−.3591	−19.0
Molean Trucking Co	−3,778	10,583	−.3570	7.9
Sherwin Williams Co	−4,299	12,069	−.3562	8.8
Warner & Swasey Co	−1,431	4,045	−.3538	.4
IPCO Hospital Supply Corp	−416	1,182	−.3516	−12.5
Hartz Mountain Corp	−1,688	4,960	−.3404	−9.8
Campbell Soup Co	−6,977	20,677	−.3374	−8.5
Wometco Enterprises, Inc	−1,040	3,138	−.3315	5.2
Ranchers Exploration & Development Corp	−1,424	4,307	−.3306	35.5
Ethyl Corp	−6,221	19,161	−.3247	−6.5
Maremont Corp	−4,112	12,905	−.3186	5.8
Royal Crown Cola Co	−2,076	6,539	−.3175	−16.0
Flight Safety International, Inc	−352	1,145	−.3077	7.2
Angelica Corp	−1,077	3,514	−.3065	4.0
VF Corp	−4,870	16,190	−.3008	−4.0
NLT Corp	−10,295	34,248	−.3006	−3.7

TOP 104 SALES RELATIVE TO VOLUME—continued

[378 funds, $44,000,000,000 in common stock holdings, June 30, 1976 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction/volume	Quarter price change
U.S. Home Corp	−$4,014	$13,622	−0.2947	−22.2
Houghton Mifflin Co	−746	2,596	−.2875	−4.5
Fieldcrest Materials, Inc	−1,487	5,226	−.2845	4.6
Peabody Galion Corp	−3,487	12,573	−.2773	9.8
Rohr Industries, Inc	−579	2,094	−.2766	−10.9
Preston Mines, Ltd	−122	443	−.2757	3.1
Great Lakes Chemical Corp., Delaware	−2,853	10,478	−.2722	−2.2
Circle K Corp	−347	1,279	−.2715	−9.6
Sargent Welch Scientific Co	−500	1,912	−.2615	0
Integon Corp	−339	1,300	−.2603	−11.9
Wackenhut Corp	−139	540	−.2569	−3.2
Kawecki Berylco Industries, Inc	−233	916	−.2542	25.0
Southwestern Public Service Co	−2,954	11,639	−.2538	−4.0
Richmond Corp	−3,648	14,433	−.2528	19.5
May Department Stores Co	−13,402	5[illegible],598	−.2501	−13.7
Walter, Jim, Corp	−10,509	42,273	−.2486	−24.3
Standard Brands Paint Co	−4,984	20,190	−.2468	−20.4
St. Regis Paper Co	−13,674	55,461	−.2466	−4.2
Tiger International, Inc	−5,965	24,715	−.2413	−3.0
Anchor Hocking Corp	−3,402	14,122	−.2409	.1
Flowers Industries, Inc	−77	320	−.2406	61.7
Gannett Inc., Delaware	−5,502	23,327	−.2359	3.5
Jewel Cos., Inc	−2,443	10,515	−.2324	−3.2
Imperial Corporation of America	−5,464	23,842	−.2292	1.0
Pacific Lumber Co	−1,857	8,121	−.2287	−6.3
Superior Oil Co	−8,701	38,261	−.2274	9.0
Flintkote Co	−2,221	9,771	−.2273	−10.0
Firestone Tire & Rubber Co	−10,076	44,988	−.2240	−1.1
Pillsbury Co	−7,627	34,129	−.2235	−3.6
Scovill Manufacturing Co	−1,548	6,978	−.2218	−6.3
Pennwalt Corp	+3,315	15,012	−.2208	5.4
Wang Laboratories, Inc	−1,107	5,087	−.2177	−12.5
National Gypsum Co	−3,057	14,474	−.2112	−7.9
Northrop Corp	−9,052	43,366	−.2087	40.7
Ryan Homes, Inc	−1,761	8,446	−.2085	−22.5
Cole National Corp	−304	1,459	−.2080	3.2
Carter Hawley Hale Stores	−4,288	20,781	−.2063	−18.2
Berven Carpets Corp	−170	838	−.2028	−32.0
Waste Management, Inc	−850	4,192	−.2028	0
Associated Dry Goods Corp	−3,881	19,162	−.2025	−19.6
American General Insurance Co	−3,171	15,735	−.2015	−9.7
McDonalds Corp	−50,924	253,580	−.2008	−8.6
Duplex Products, Inc	−273	1,362	−.2004	−20.3
Russ Togs, Inc	−772	3,881	−.1989	−20.4
Supermarkets General Corp	−413	2,082	−.1981	−17.0
Superscope, Inc	−3,661	18,569	−.1971	−25.0
Sambo's Restaurants, Inc	−3,811	19,598	−.1945	−11.1
Kaneb Services, Inc	−1,818	9,371	−.1941	23.1
Federal National Mortgage Association	−12,982	67,356	−.1927	−11.5
Garfinckel Brooks Bros., M. & R.	−597	3,098	−.1927	−1.6
Hall, Frank B., & Co., Inc	−605	3,232	−.1871	−8.5
Cooper Industries, Inc	−3,412	18,427	−.1852	18.7
Martin Processing, Inc	−1,460	7,913	−.1845	−17.4
Golden West Financial Corp., Delaware	−1,637	8,925	−.1834	−7.1
Phelps Dodge Corp	−10,901	59,491	−.1832	−1.4

TOP 104 PURCHASES RELATIVE TO VOLUME

Imperial Chemical Industries, Ltd	2,664	65	41.2724	−18.3
Matsushita Electric Industrial, Ltd	85,187	16,747	5.0866	11.9
Ford Motor Co. Canada, Ltd	934	936	.9987	−2.5
New York Times Co	3,003	3,308	.9077	0
Northwest Industries, Inc	33,023	48,996	.6740	13.7
Interpublic Group Cos, Inc	1,608	2,919	.5508	−7.7
Lehigh Portland Cement Co	993	1,901	.5223	−.9
Philips Industries, Inc	994	1,955	.5082	0
Medusa Corp	1,587	3,329	.4769	0
Block H. & R., Inc	4,872	10,274	.4742	−3.6
Cox Broadcasting Corp	2,756	5,973	.4614	11.0
Chieftain Developers, Ltd	538	1,211	.4443	26.0
Pay Less Drugstores Northwest	1,562	3,549	.4401	−3.3
British Petroleum, Ltd	3,550	8,249	.4303	−8.6
General Cinema Corp	2,541	5,930	.4286	2.4
Babcock & Wilcox Co	14,575	34,639	.4208	26.0
Lone Star Industries, Inc	3,217	7,800	.4125	−6.5
Borden, Inc	15,313	37,967	.4033	7.6
Munsingwear, Inc	255	638	.3996	−6.2
Green Giant Co	839	2,164	.3878	−5.3
Castle & Cooke, Inc	2,147	5,905	.3636	−1.5
Taft Broadcasting Co	1,852	5,242	.3534	23.5
Champion International Corp	18,557	52,529	.3533	9.1
Bank New York, Inc	2,096	5,968	.3512	−2.7

TOP 104 SALES RELATIVE TO VOLUME—Continued

[378 funds, $44,000,000,000 in common stock holdings, June 30, 1976 quarter]

Name	Fund transactions (thousands)	Market volume (thousands)	Transaction volume	Quarter price change
Ogden Corp	$2,754	$8,072	0.3412	12.3
Baltimore Gas & Electric Co	6,947	20,499	.3389	2.7
Chouse-Hinds Co	4,211	12,772	.3297	25.6
Tektronix, Inc	10,509	32,443	.3239	6.7
Freeport Minerals Co	4,260	13,383	.3183	1.4
First International Bancshares, Inc	6,569	21,014	.3126	3.4
Emery Industries, Inc	765	2,504	.3055	−7.3
Martin Marietta Corp	13,306	44,290	.3004	19.3
Reliance Electric Co	8,566	28,636	.2991	25.8
Mayer Oscar & Co., Inc	643	2,158	.2981	−7.6
Dravo Corp	1,351	4,984	.2711	−1.6
El Paso Co	6,091	22,506	.2706	−1.8
Gearhart, Owen Industries, Inc	3,377	12,918	.2614	22.6
Hobart Corp	997	3,840	.2598	−1.4
Texas Oil & Gas Corp	8,185	31,736	.2579	31.8
Zimmer Homes Corp	447	1,738	.2573	−5.7
McDonnell Douglas Corp	13,117	51,066	.2569	33.8
Washington Real Estate Inventory Training	183	713	.2566	7.4
Smiths Transfer, Staunton, Va	550	2,185	.2518	2.2
Bemis, Inc	363	1,466	.2478	−5.1
ITEL Corp	3,575	14,555	.2456	20.9
Parker Hannifin Corp	3,677	15,447	.2380	15.1
Missouri Pacific Railroad Co	2,402	10,153	.2366	2.9
Combustion Engineer, Inc	9,125	38,619	.2363	20.9
Great Western Financial Corp	7,522	32,658	.2303	.7
Fluke, John, Manufacturing, Inc	462	2,024	.4281	−9.3
Smith Kline Corp	15,813	69,383	.2279	4.2
McGraw Hill, Inc	2,394	10,712	.2235	−.8
Gould, Inc	13,238	59,724	.2217	26.1
Robertson, H. H., Co	404	1,868	.2161	−11.2
Rex Noreco, Inc	70	328	.2135	50.0
Brown Forman Distillery CL B	483	2,281	.2118	−18.6
Lea Ronal, Inc	213	1,012	.2100	−7.2
Kerr McGee Corp	24,208	115,401	.2098	13.7
Airco, Inc	7,634	36,747	.2077	26.4
Sedco, Inc	5,121	24,682	.2075	26.8
Fairchild Camera & Instrument Co	14,990	72,344	.2072	24.2
Saul B. F. Real Estate Investment Trust	323	1,562	.2070	3.4
Inland Container Corp	1,863	9,021	.2065	.9
Interway Corp	241	1,195	.2014	−1.3
Florida Gas Co	1,603	8,040	.1994	8.5
Union Oil Co., California	20,947	105,961	.1977	19.3
Morton Norwich Products Inc., Delaware	2,192	11,132	.1969	−4.8
Coachmen Industries, Inc	2,631	13,370	.1968	−10.1
Prentice Hall, Inc	1,258	6,427	.1957	−9.6
Loews Corp	3,628	18,825	.1927	−6.1
Cleveland Cliffs Iron Co	1,514	7,896	.1917	11.4
Tampa Electric Co	3,424	17,930	.1910	−4.3
Mountain Fuel Supply Co	5,173	27,359	.1891	8.4
Gerber Products Co	1,837	9,846	.1866	6.8
Midland Ross Corp	1,525	8,355	.1825	5.0
Molycorp, Inc	2,680	15,081	.1777	33.8
Polaroid Corp	35,952	203,718	.1765	8.7
Boeing Co	27,307	156,184	.1748	51.6
American District Telegram Co	1,501	8,606	.1744	−8.5
Crocker National Corp	2,782	15,973	.1741	5.4
Ideal Basic Industries, Inc	1,323	7,677	.1723	8.3
Norris Industries, Inc	3,025	17,563	.1723	14.5
Harcourt Brace Jovanovich	1,126	6,555	.1718	7.2
Seligman & Latz, Inc	507	3,050	.1664	−4.6
Fruehauf Corp	3,613	21,905	.1649	11.5
Rockwell International Corp	7,391	45,338	.1630	5.9
Parker Drilling Co	2,785	17,167	.1622	20.2
Ryder Systems, Inc	4,735	29,488	.1606	24.2
United Realty Trust	150	952	.1576	4.3
IO Industries, Inc	1,668	10,606	.1573	6.8
Oak Industries, Inc	186	1,194	.1560	28.9
Mohawk Rubber Co	173	1,114	.1555	−1.8
Wrigley, Wm. Jr., Co	1,646	11,028	.1493	18.0
Entex, Inc	1,000	6,721	.1488	16.8
Allied Stores Corp	6,927	46,879	.1478	−12.9
Rosario Research Corp	1,455	9,913	.1467	2.9
Potlatch Corp	2,680	18,427	.1454	9.0
Utah Power & Light Co	2,959	20,416	.1449	9.1
NL Industries, Inc	5,241	36,272	.1445	20.1
Ranger Oil Canada, Ltd	355	2,460	.1443	22.4
Sybron Corp	998	6,977	.1431	−5.3
First Chapter Financial Corp	4,042	28,666	.1410	−5.6
Wheeling Pittsburgh Steel Corp	436	3,094	.1409	7.9
Edison Bros. Stores, Inc	670	4,821	.1389	−11.5

QUARTER PRICE CHANGE

Grand squared deviations	201614.33843849
Squared deviations between classes	11299.39262864
Squared deviations within classes	190314.94581007
Number of classes	10 (N1=9 D.F.)
Number of observations	038 (N2=1,028 D.F.)
F=(SDBC/N1)/(SDWC/N2) equals	6.782

	Count	Transaction/volume average	Quarter price change average	Quarter price change standard development
Class:				
1	104	−0.3614	−5.6179	13.7541
2	104	−.1432	−2.5905	11.8343
3	103	−.0865	1.9884	12.9507
4	104	−.0494	.8645	12.0747
5	104	−.0219	1.8444	15.5559
6	104	.0011	2.6510	14.6468
7	104	.0235	3.1846	13.8610
8	103	.0529	3.5979	13.5793
9	104	.1051	2.7948	13.0595
10	104	.7112	7.0085	13.6750
Total	1,038	.0232	1.5702	13.9368

Senator BENTSEN. As a courtesy to Mr. Smith, we will let him have the same amount of time.

Mr. Smith.

STATEMENT OF HARRISON V. SMITH, EXECUTIVE VICE PRESIDENT OF THE MORGAN GUARANTY TRUST CO.

Mr. SMITH. My name is Harrison V. Smith. I am an executive vice president of Morgan Guaranty Trust Co. of New York and head of its trust and investment division. We have submitted a statement, but I will summarize our views on S. 901 and S. 285.

On S. 901, we have been asked if we have comments on this bill and we do. They are basically favorable, because we are pleased with the committee's constructive efforts to remedy deficiencies in the workings of ERISA. We do have four suggestions that are set out in the statement. They deal with the assigning of responsibility for the administration of ERISA through the Department of Labor; replacing the list of prohibited transactions with a more work-a-day rule; dropping, as unnecessary, the provisions for civil penalties for party-in-interest transactions; and amending section 404(a) to assuage the concern of some investors about ERISA's authority about investment in smaller companies. Language for such an amendment has been submitted with my full statement.

Turning now from S. 901, I am sorry to say that we have a much less favorable view of S. 285.

We believe that this bill is based on important misconceptions of the nature of the pension investment business and that, if it became law, it would diminish rather than increase the prospects for the safe and successful investment of the $240 billion in private pension-plan assets that are to provide retirement income to millions of American workers.

In our view, there are four principal misconceptions.

One, investments would be more diversified if smaller managers as a group had more assets under management and large managers had less. The fact is that larger bank trust departments are more diversified than smaller ones and that Morgan Guaranty, instead of being an example of poor diversification, is ahead even of the other large trust departments.

Two, pension managers need the provisions of this bill to invest in smaller companies. The fact is the Morgan Guaranty has been investing pension assets in small and medium companies for more than 15 years. We believe that this can be done prudently under existing laws, although it requires resources of people and money not available to smaller institutions.

Three, large pension managers have a dominant power over securities prices. A stringent examination of the actual effect of institutional activity on market prices disproves this belief.

Four, unless certain pension managers are limited in their investments, they will achieve too much control over the economy. The fact is that there is no such danger.

As to the misconception about diversification, we have found no reliable evidence indicating that institutionally managed pension portfolios are inadequately diversified and, hence, exposed to undue risk. On the contrary, the weight of informed thinking on the subject is that diversification is more than adequate for the purpose of minimizing risk.

In the case of Morgan Guaranty, the data show that our holdings are more diversified than those of banks in our own category of size as well as smaller banks. Specifically, the number of stocks we hold and follow is five times as large as that in the average bank trust department and 85 percent greater than the average of the other largest ones.

Over 800 equity issues are held for our pension clients, of which only 9 account for more than 1 percent each of pension assets. In terms of equities only, the 10 largest holdings in our pension trusts accounted for 22.6 percent of the value of total pension equities, compared with 37 percent for other large banks and about 29 percent for the Standard & Poor's Composite Index of 500 stocks.

The reason we can diversify prudently is that we have the resources to do so and these resources are a function of size. They include a research staff of 70 analysts and the investment and administrative capability of maintaining 14 commingled pension trust funds so that even the smallest trust under our management can be diversified as broadly as the largest. As a consequence, the typical pension account has an interest in 642 equities.

Another misconception is the idea that investment managers need additional legislation before they can invest pension funds in smaller companies. The provisions of ERISA are often cited in this connection. We find these concerns somewhat puzzling. It is true that ERISA made a lot of people fiduciaries who had not so regarded themselves previously, but this obviously did not change the status of banks like ourselves; we have always been fiduciaries and are accustomed to the status.

Nor is there anything in the legislative history of ERISA to indicate that one of its purposes is to discourage the investment of pension money in smaller companies. Instead, the law mandates diversification—certainly encouraging to broadly invested portfolios such as ours. The Federal prudent man rule in ERISA is, if anything, more liberal than the rule we had been operating under.

Although I know this committee is clear on the point, perhaps some people confuse venture capital investments with all investments made in small companies. Of course, they are not at all the same thing. A venture capital investment is an investment in a company which is not only in an early state of development but has only securities which are privately held.

In other words, venture capital companies have yet to go public. Venture capitalists are entrepreneurs who must be prepared to tie up their money until there is a public market for the company's securities, to participate actively in the direction and management of the company and to run the risk of what is often said to be a 70 percent to 90 percent failure rate—all in the hope of commensurate gain.

We believe that this important function is not a suitable one for bank trust departments investing pension funds. In our view, it should be left to the numerous venture capital firms that specialize in this activity.

Although we have generally stayed away from venture capital investments as we define them and feel that we should continue to do so, we have a long history of investing in small and medium-sized companies.

One of our division's commingled funds, the special situation investments equities fund, has invested in more than 400 companies since it was created 16 years ago. The smallest of these had a market capitalization at the time of investment of less than $10 million and the largest approximately $100 million.

I should perhaps add that from its inception in its present form in 1964 through the end of 1976, this fund showed a time-weighted compounded annual rate of return of 9.1 percent a figure which can be compared with a 5.8 percent annual return for our portfolio of large companies over the same period and 5.9 percent for the S. & P. 500—all of which gives us every incentive to continue to seek out smaller companies with attractive prospects.

Nor is this fund small or otherwise insignificant in our scheme of things. Its holdings in 218 companies had a market value of $656 million at the end of last year and typically represented 6.7 percent of the market value of the common stocks in a participating pension fund.

An even larger proportion—8.3 percent—was invested in another of our commingled funds that concentrates on medium-sized companies. Its year-end market value was $817 million, representing holdings in 136 equities.

Partly as a consequence of the investment in these funds, the companies in which we have concentrations are for the most part not the giants. For instance, more than 80 percent of the companies in which our division at year-end held more than 5 percent of the outstanding shares had market capitalizations of less than $500 million and 55 percent had market capitalizations of less than $100 million. Of our 123 pension-trust holdings that exceeded 5 percent of common stock outstanding at the end of last year, fully 98 were in companies having a net worth of less than $150 million, the line of demarcation that would be set by the bill.

When our analysis leads us to conclude that a smaller company's future is sufficiently attractive to offer a return commensurate with the risk involved, we are able under existing legislation to invest our pension client's money in that company. At the same time, we would not under any circumstances invest in a small company where our analysis suggests the risk outweighs the possible return.

S. 285 is also, in our view, based on misconceptions concerning the power of large trust departments over securities prices. We have seen no hard evidence contradicting the conclusion of the SEC's 1971 institutional investor study that "institutional trading overall has not impaired price stability in markets." More recent studies by highly respected academic theoreticians have confirmed the SEC study's finding.

Mr. Schotland is right that it would have been better if we had used our in-house information and we will recast them in that form and submit them to your committee. We do not believe that this would result in a substantial change in the conclusions.

[The following was subsequently supplied for the record. Oral testimony continues on p. 287.]

MORGAN GUARANTY TRUST COMPANY OF NEW YORK,
New York, July 20, 1977.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During my testimony before your subcommittee on June 28, 1977, I agreed to supply a revised appendix F to my statement using Morgan Guaranty's own trading data rather than the commercially prepared data used by Professor Schotland and in our original study. This document, denoted as revised appendix F to distinguish it from its predecessor, is enclosed.

In our judgment, the results again clearly reveal the absence of a significant and consistent link between our proportion of a stock's trading volume and its price behavior.

As to your questions about statistical tests of our appendix F, it should be noted that our examination was designed to test Professor Schotland's allegation that what he called our "dominant" trading in certain stocks determined their price behavior. The stocks examined were those selected by Professor Schotland in support of his contention. The data plottings in revised appendix F do not appear to provide justification for extending the analysis to include stocks in which we accounted for a lesser proportion of total trading or for applying tests of significance that would appear to be irrelevant in the absence of any indication of statistically meaningful relationships.

We have responded in the enclosures to two of your other requests, for the print-out of all the underlying data, and the average and the standard deviation data on the price change during the period in question for the "buy" group and for the "sell" group.

Your other request, for "all correlation and regression statistics," is not so easily satisfied. For one thing, there is a considerable volume of such statistics, and it is not feasible—or meaningful—for anyone to interpret them without first defining the kind of analysis that is contemplated. We are perfectly willing to discuss at an appropriate time this essentially technical matter with statisticians the subcommittee may have assisting it.

In connection with the indications of your desire to test the validity of testimony presented at the hearing, we have requested from your staff an opportunity to see Professor Schotland's studies and underlying data on reporting banks and reporting mutual funds as well as the analysis he claims would set aside some of the findings on the Securities and Exchange Commission's Institutional Investor Study. We believe you and your colleagues should have the benefit of thorough analyses of the Schotland study which has led to conclusions so completely at odds with the findings of the many other studies that have been performed on this same subject. Assuming we receive the studies soon, we plan to analyze them and send our findings to you while the record is still open.

Sincerely,

H. V. SMITH.

Enclosures.

ANALYSIS OF WHETHER MORGAN GUARANTY'S TRADING DETERMINES STOCK PRICES

In a paper entitled "Bank Trust Departments and Public Policy Today" [1] Professor Roy Schotland has suggested there is a point beyond which a single institutional investor accounts for so much buying or selling of stocks that the institutional investor cannot avoid setting the market price for those stocks. He further suggests Morgan Guaranty has passed that point. In support of his contention, those stocks in which the bank's net purchases or sales for clients accounted for over 5 percent of annual trading volume in the respective shares for the years 1973, 1974, and 1975 were listed. Specifically, in 1975 he cited 33 companies in which Morgan Guaranty's net purchases for clients accounted for 5 percent or more of the total trading volume in those stocks. Likewise, he listed 21 companies in which net sales for clients accounted for 5 percent or more of the total volume in those stocks. Similar data was presented for the years 1973 and 1974. The inference he draws is that, at least for the stocks indicated, Morgan Guaranty's activities on behalf of its clients resulted in setting the market prices for these stocks.

Professor Schotland has raised an important question. Specifically, does the fact that an institution may account for a sizable percentage of a stock's volume imply that the institution will have a measurable, and presumably adverse, impact on the stock's price? Our initial response would be to express doubt, since several generations of experience in the investment business show that customers tend to be happier when we buy low and sell high. That is, it is strongly in our own self interest to be sure that our trading for clients does not have any impact on market prices. Furthermore, in recent years our view has been shaped by conclusions such as those presented in the 1971 Study of Institutional Investors conducted by the Securities and Exchange Commission. This study concluded that "institutional trading overall has not impaired price stability in markets." [2] And that, "Banks . . . tend to be price neutral: their net trading imbalances tend to be in the opposite direction to price change as frequently as they are in the same direction." [3] Nevertheless, our respect for Professor Schotland and his deep interest in public policy issues relating to bank trust departments has led us to employ statistical tools in an effort to expand on his initial analysis of this matter. Specifically, we have sought to determine whether Morgan Guaranty's percentage of trading in the stocks he mentioned did, in fact, have an impact on the price behavior of these same stocks. A description of this effort and the overall conclusions are presented in the following sections. Subsequently, a somewhat more technical discussion of the statistical analysis is presented.

Brief description of the analysis

The stocks in which Morgan Guaranty's trading for clients accounted for a substantial portion of annual volume have been examined to see if there was any common trend in price change. The study has focused on stocks cited by Professor Schotland as those transactions for which Morgan Guaranty accounted for 5 percent or more of total 1975 or 1976 trading. This relationship was examined for 32 of the net purchases and 16 of the net sales in 1975 which Professor Schotland cited, as well as for all 74 [4] stocks in which Morgan Guaranty's trading amounted to over 5 percent of total volume in 1976.[5] The revised study has eliminated 26 trading volume was below the 5 percent criterion set by Professor Schotland.

[1] Prepared for the financial institutions and the Nation's economy (FINE) Study of the Committee on Banking, Currency and Housing, U.S. House of Representatives (June, 1976).
[2] Institutional investor study report of the Securities and Exchange Commission (1971) summary volume, p. XXI.
[3] Op. cit., p. 84.
[4] There were 41 net purchases and 33 net sales.
[5] Morgan's quarterly volume was extracted from internal records; New York Stock Exchange volume data were provided by Compustat.

stocks examined in the original study (six in 1975 and 20 in 1976) because our

(The study was limited to 1975 and 1976 since quarterly trading volume was not readily available for prior years.) Since trading was not necessarily continuous or evenly distributed throughout 1975 and 1976, the relationship between volume and share price movement was examined on a quarterly basis. That is, the proportion of quarterly volume accounted for by Morgan Guaranty's transactions was calculated for 48 stocks in 1975 and for 74 stocks in 1976. Subsequently, the quarterly price changes for these same stocks was derived. These price changes were then adjusted to remove the effect of price movement trends for the stock market as a whole—a factor which typically explains 30 percent-40 percent of a single stock's price variability. For example, where a stock rose 15 percent and the S.&P. rose 10 percent, the market—adjusted price change would be 5 percent (15 percent minus 10 percent). These data are presented graphically in charts 1 through 16, which are attached and further described.

Conclusions

Visual examination of these data provides little evidence that there has been any meaningful relationship between the percent of a stock's trading attributable to Morgan Guaranty and its price behavior. For the most part, the data appear wildly behaved and generally unpredictable. Statistical analysis of the data, discussed in the subsequent section, confirms this visual examination. We have not been able to find any relationship between percentage change in price and the fraction of trading that Morgan Guaranty accounts for. Consequently, we conclude very strongly that Morgan Guaranty has not, in fact, set prices for this group of stocks.

We would further note that this test has been limited to those stocks in which Morgan Guaranty's 1975 and 1976 trading activity has been described as substantial. As such, the group of stocks is not representative of the bank's overall trading activity. In fact, it dramatically overstates Morgan Guaranty's overall presence in the trading of common stocks, which amounted to only 2 percent-3 percent of total N.Y.S.E. volume in 1975 and 1976.

The overall conclusion is not surprising in light of the generally held belief that domestic security markets are reasonably efficient. For this to be so, there must be a willing seller of every share Morgan Guaranty, or any other investor, wishes to purchase and a willing buyer for every share Morgan Guaranty wishes to sell. Furthermore, the conclusion is quite consistent with policies our traders have followed for many years, namely, that every effort should be made to ensure that the bank's transactions for clients do not impact securities prices.

Summary of statistical analysis

The objective in the various analyses we have done is to attempt to test the hypothesis suggested by Professor Schotland that our equity trading above 5 percent of the volume in some sense "determines" price.

Professor Schotland's concern was qualitatively stated; he did not specify a particular mathematical equation for this "determining" relationship and so we have applied various plausible particular model specifications. We used linear regression models based on ordinary least squares. The formal statistical tests of significance are based upon the assumption that the dependent and independent variables are jointly normally distributed. All the models we tested exhibited great instability in the coefficients from quarter to quarter and between purchases and sales. We modeled purchases and sales both separately and together.

We have not been able to find any meaningful relationship between percentage change in price and the fraction of trading volume that we have accounted for in our purchasing and selling programs.

The purchases and sales data are displayed in charts 1-16. The data presented in these charts are quarterly data. The first eight charts are for the four quarters of 1975, the last eight are for 1976. In charts 1-16 the variable plotted on the vertical axis is the percentage change in equity price normalized by the simultaneous percentage in market price (P). The variable on the horizontal axis is the percentage of trading volume accounted for by Morgan Guaranty (M). We adopt the convention that buying volume is positive and selling volume is negative. The "zeros" in the charts are symbols for individual observations on companies. The numerals show coincident data points, a "2" for two such points, a "3" for three, etc. For illustrative purposes, several companies are identified by name on each chart.

In the cases—a distinct minority—where coefficients appear to be "significant," we find that the coefficients are very sensitive to the presence or absence of a small number of outliers. This is a very familiar problem in the statistical analysis of data which is non-normal because of astationarity or contamination of the process. For example, in testing the model: P equals a plus bM. on the fourth quarter sales data for 1975 shown in chart 8 we found a marginally significant b-coefficient of about 0.8. Removal of two outliers changes the estimate of b to -0.02 and the t-statistic from 2.02 to -0.03.

The coefficients are not consistent even with respect to sign. In both the third and fourth quarters of 1976 the sales data—charts 15 and 16—coefficients are negative which implies that the "effect" of Morgan Guaranty's trading is the opposite of what Professor Schotland would expect. Indeed, seven of the 16 b-coefficients found by testing the above model on the data in charts 1–16 are negative.

Inspection of these charts and analysis of the data exhibited there lead us to believe that no meaningful relationship in fact exists. If the Committee should care to pursue this investigation further, we shall be happy to offer continued assistance.

Chart 1

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - First Quarter Net Purchases

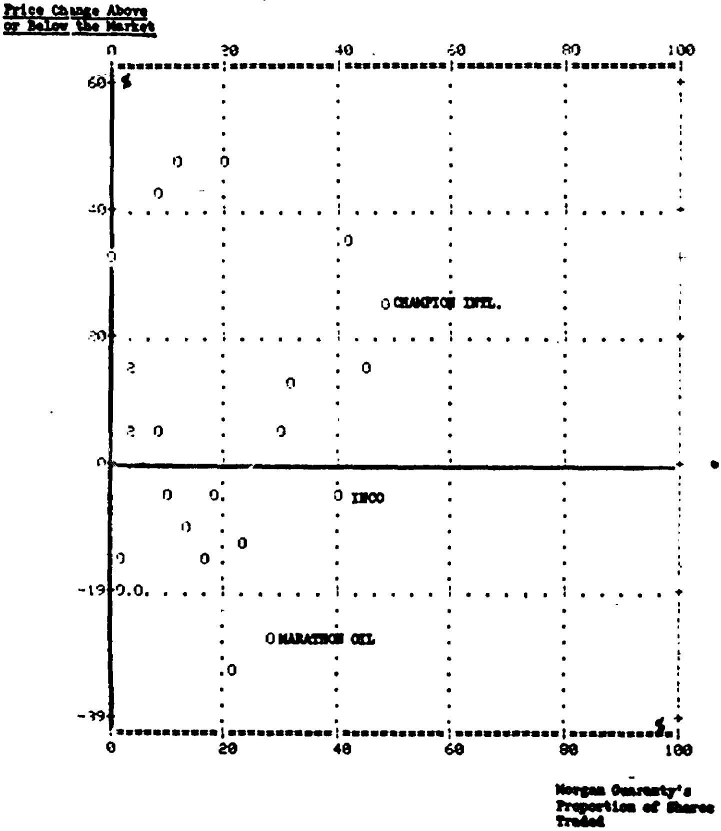


Chart 2

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Second Quarter Net Purchases

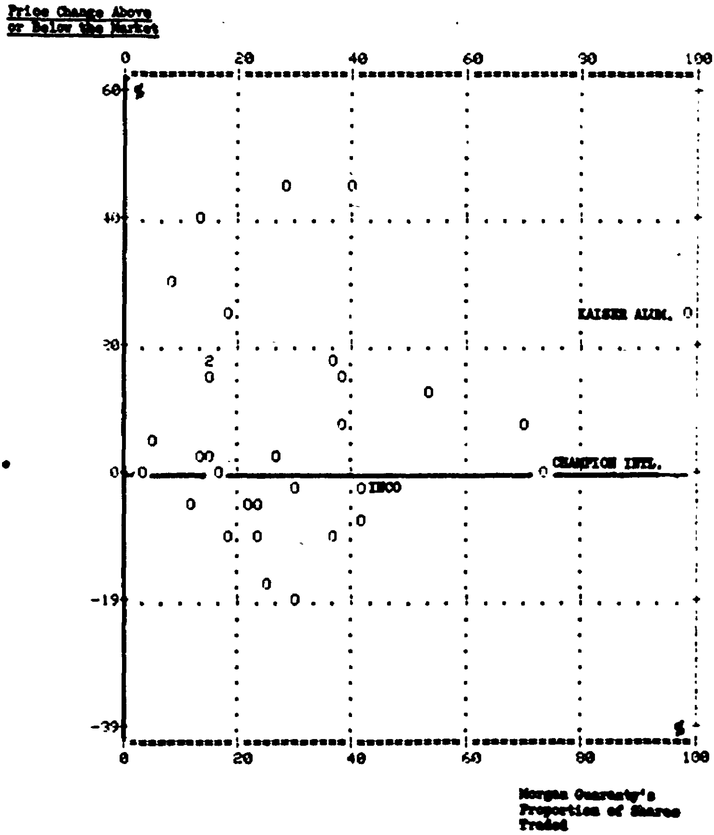


Chart 3

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Third Quarter Net Purchases

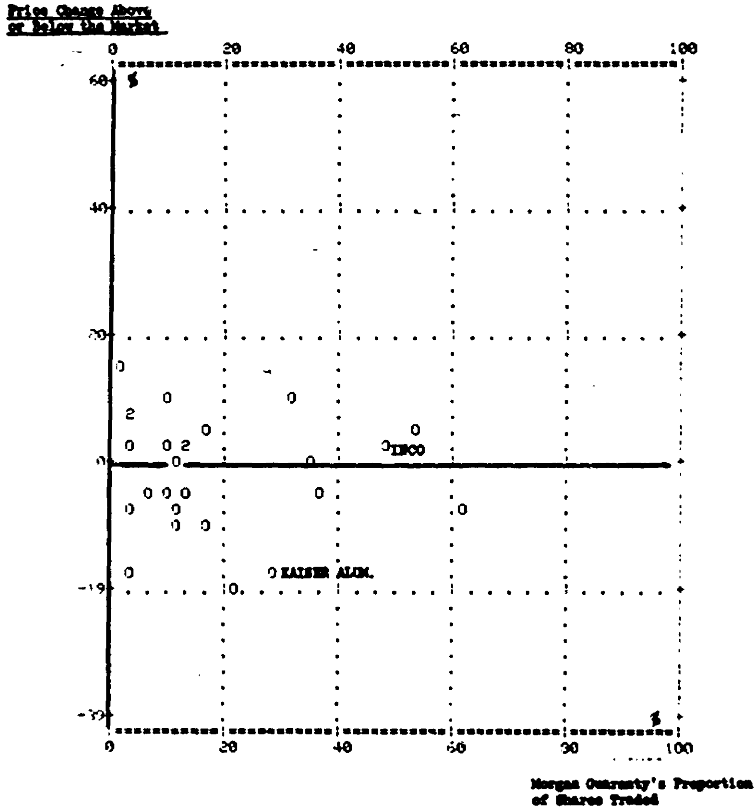


Chart 4

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Fourth Quarter Net Purchases

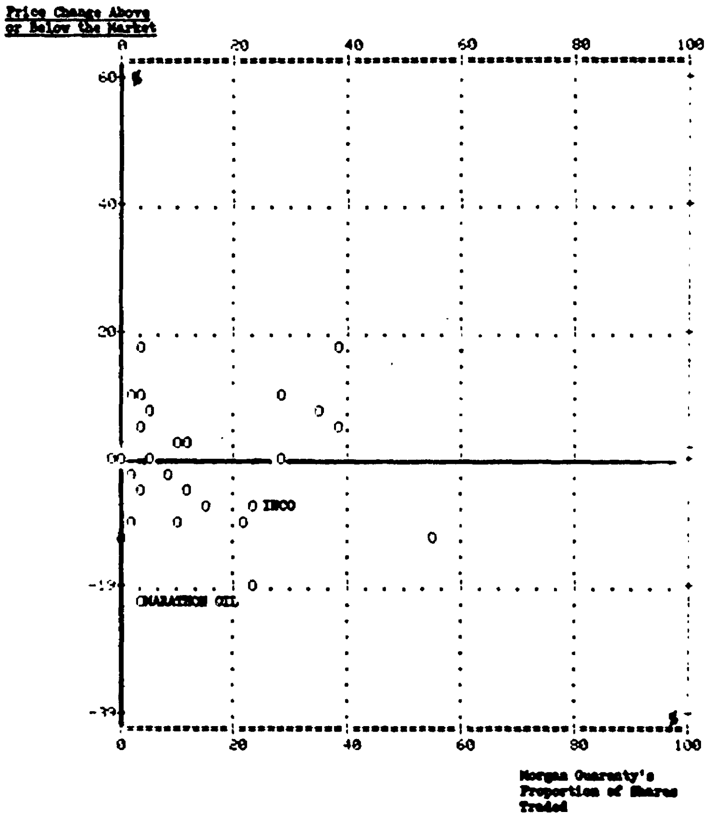


Chart 5

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - First Quarter Net Sales

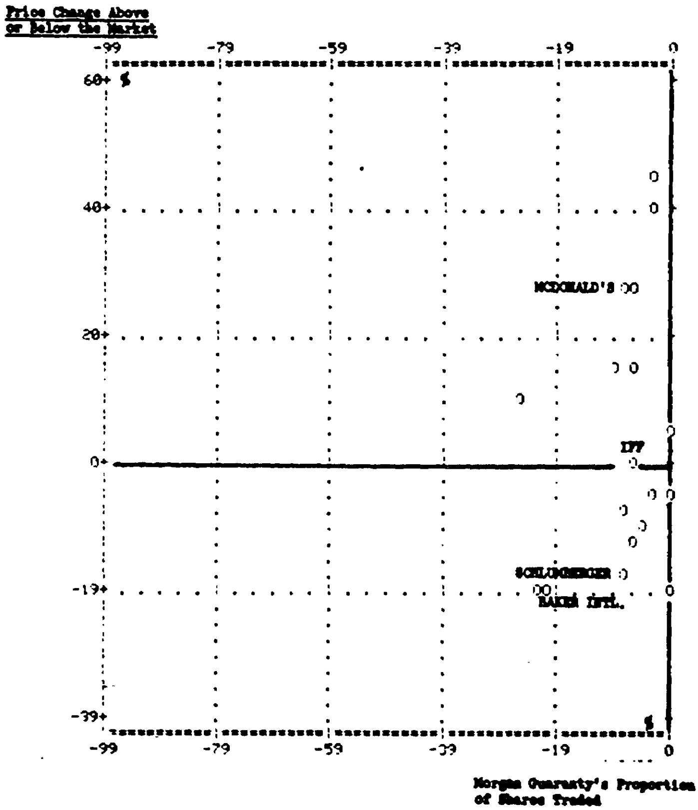


Chart 6

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Second Quarter Net Sales

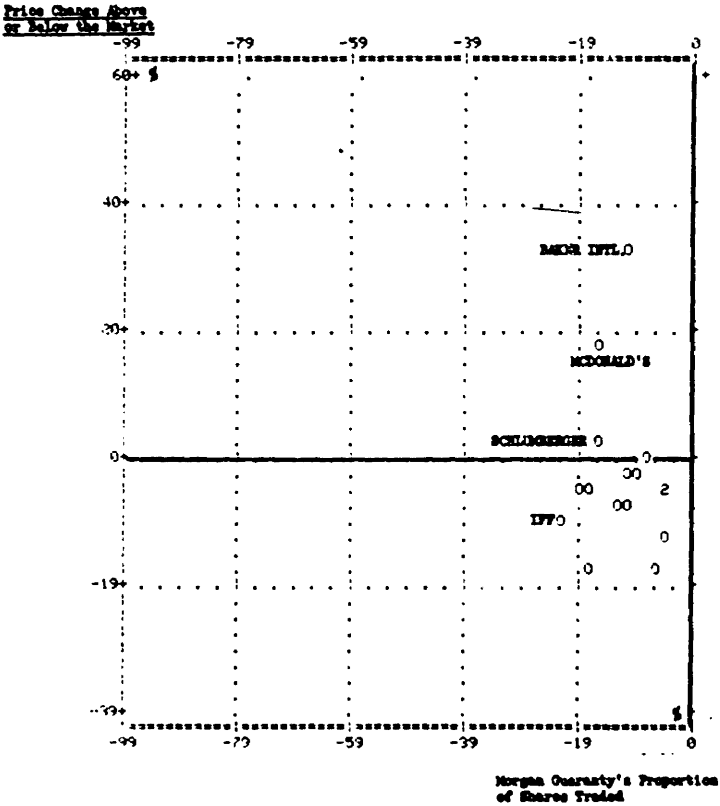


Chart 7

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion
of Total Volume - Third Quarter Net Sales

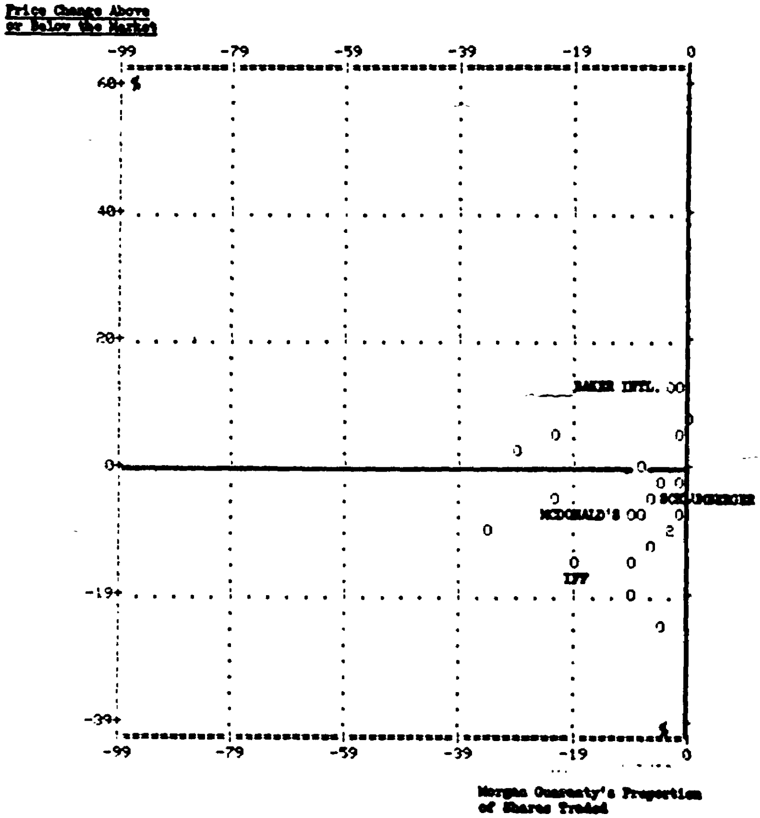


Chart 8

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1975 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Fourth Quarter Net Sales

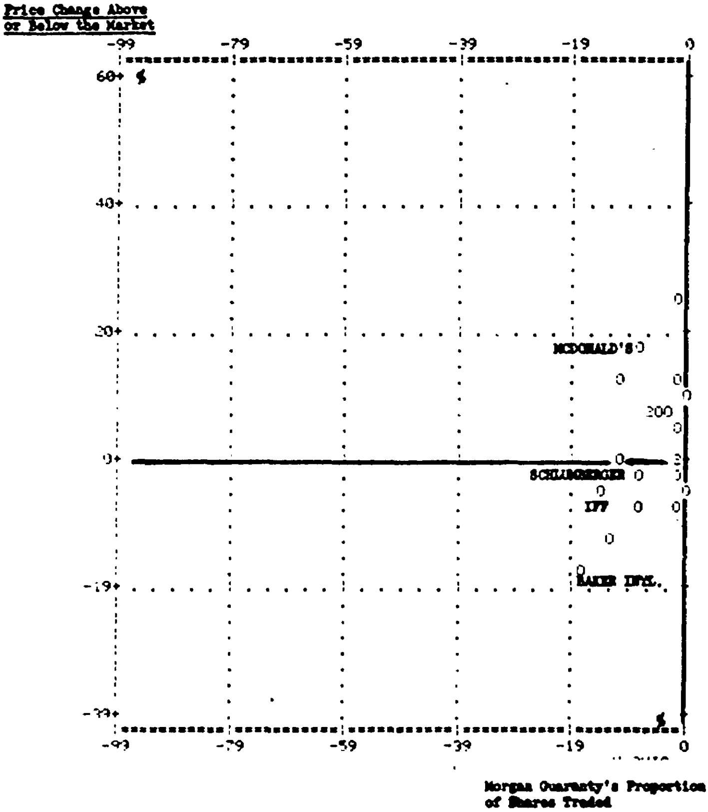


Chart 9

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - First Quarter Net Purchases

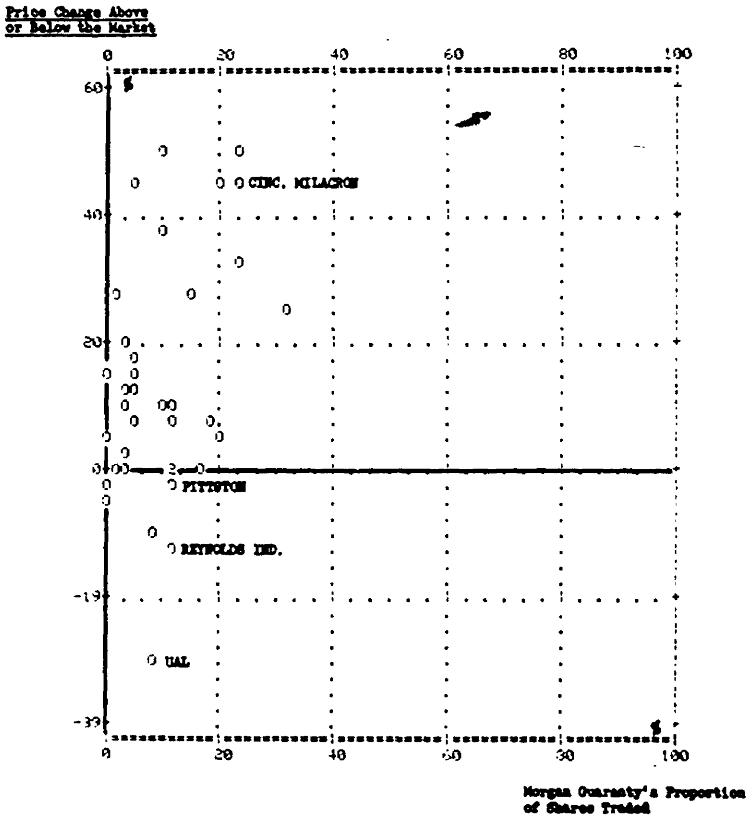
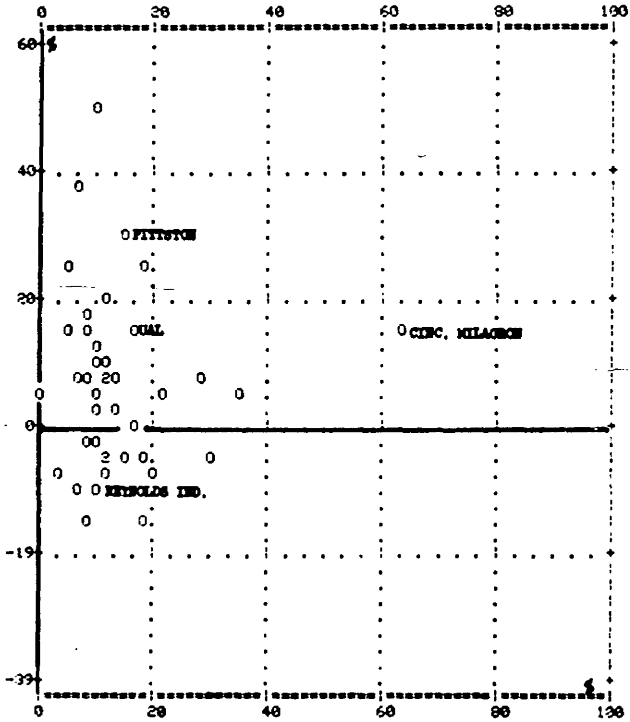


Chart 10

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Second Quarter Net Purchases

Price Change Above or Below the Market



Morgan Guaranty's Proportion of Shares Traded

Chart 11

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Third Quarter Net Purchases

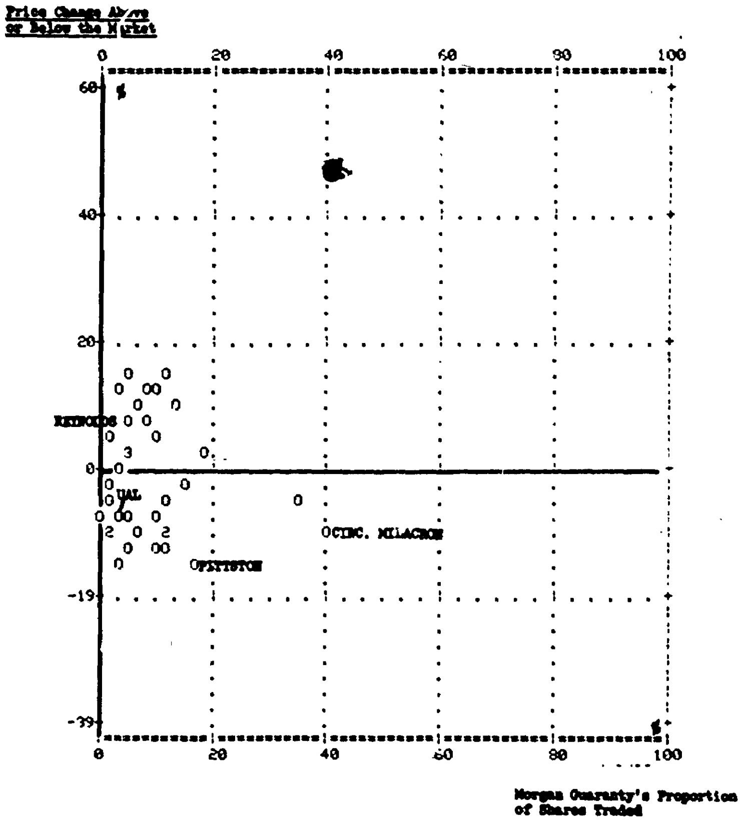


Chart 12

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Fourth Quarter Net Purchases

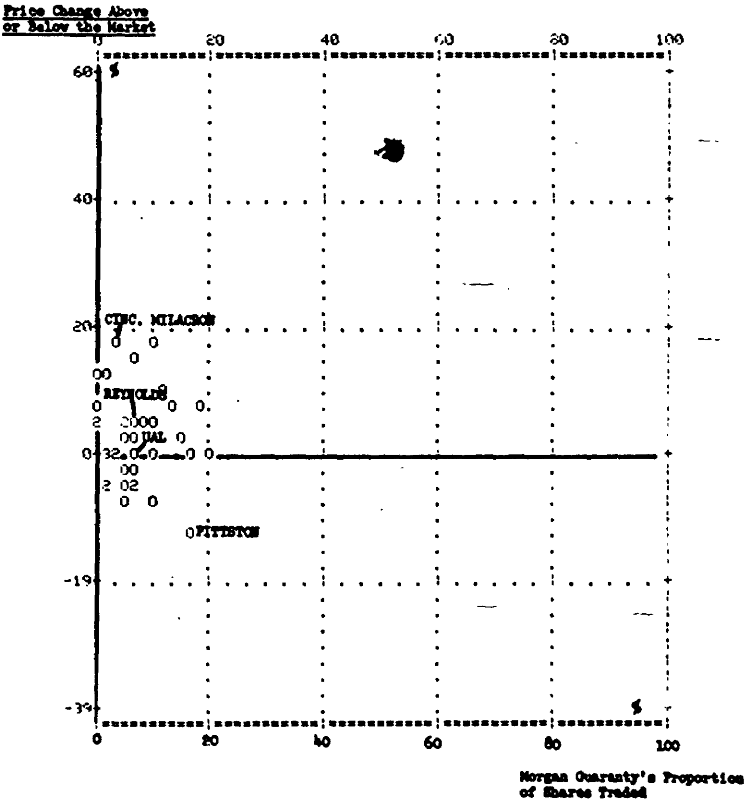
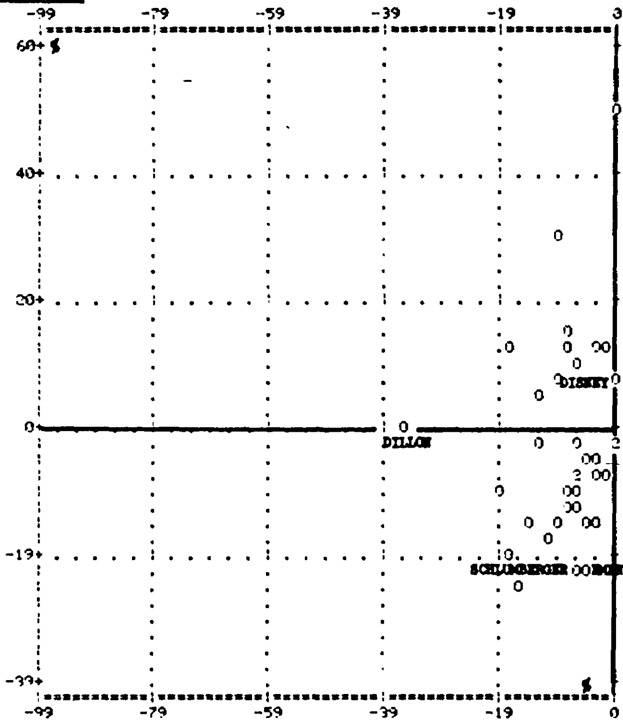


Chart 13

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - First Quarter Net Sales

Price Change Above or Below the Market



Morgan Guaranty's Proportion of Shares Traded

Chart 14

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Second Quarter Net Sales

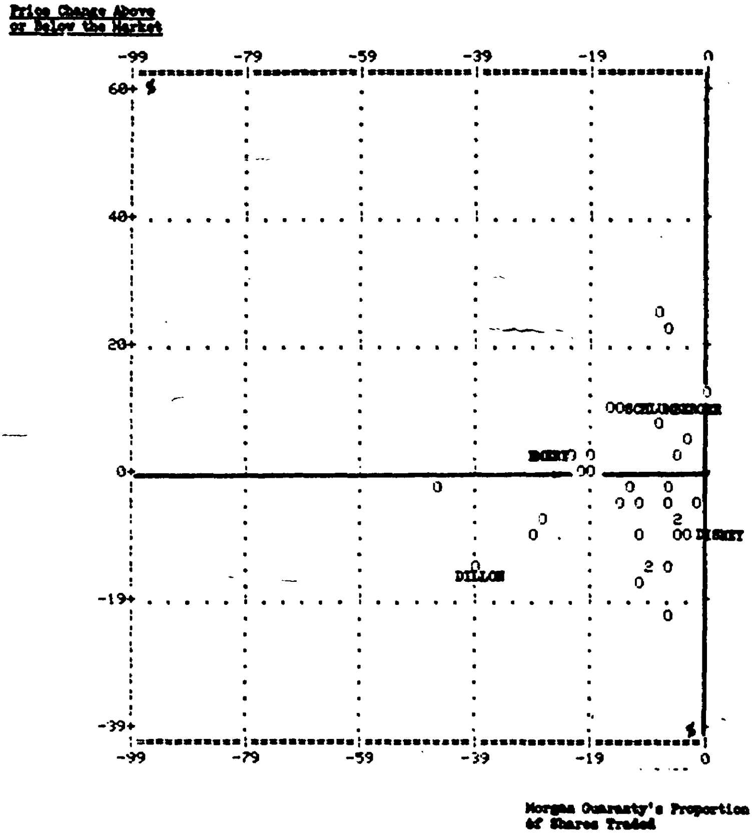
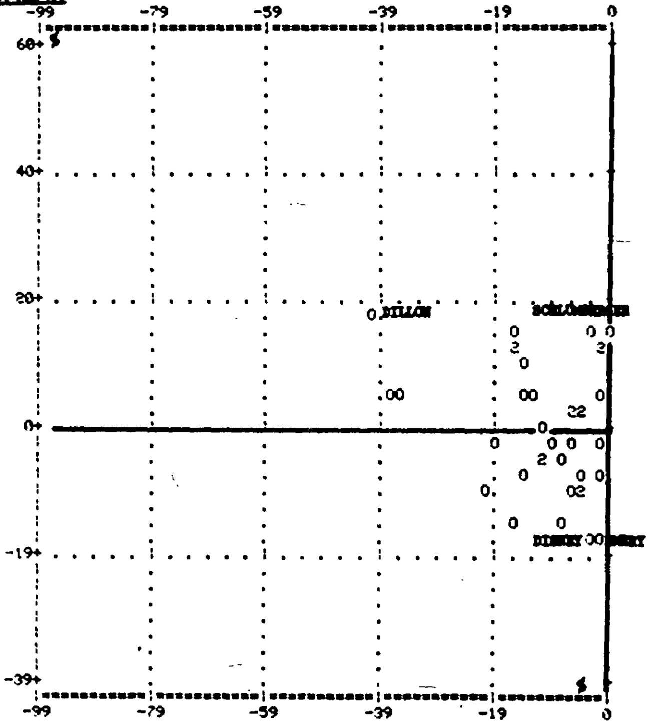


Chart 13

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Third Quarter Net Sales

Price Change Above or Below the Market

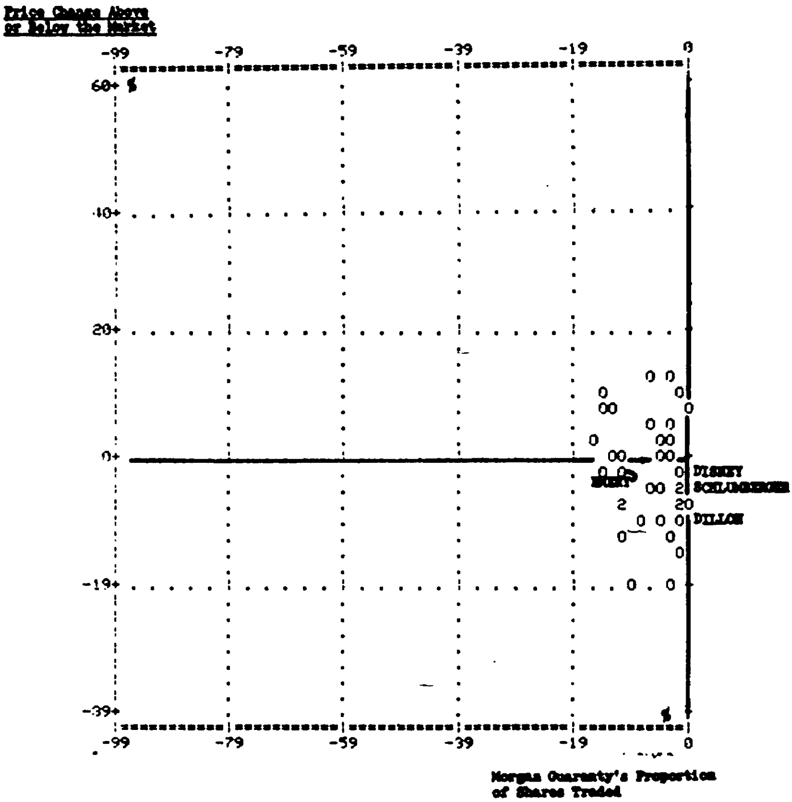


Morgan Guaranty's Proportion of Shares Traded

Chart 16

BEHAVIOR OF MORGAN GUARANTY'S MAJOR 1976 TRANSACTIONS

Price Change Vs. Morgan Guaranty's Proportion of Total Volume - Fourth Quarter Net Sales



Description of Data Included in Tables 1 through 16

The universe of companies under study for 1975 and 1976 consists of those companies identified by Roy Schotland[1] as companies in which Morgan Guaranty's net trading volume for the year exceeded five percent of total trading volume where in fact our trading volume actually did exceed five percent. In 1975 there were 48 such companies (32 purchases and 16 sales) and in 1976 there were 74 companies (41 purchases and 33 sales).

The Data

The data presented in tables 1 to 16 consists of Morgan Guaranty's quarterly trading as a percentage of total quarterly trading volume and the quarterly net percent price change[2] for the above identified companies. The Company name is in column (A), Morgan Guaranty's quarterly trading as a percent of total quarterly trading volume is in column (B) and the quarterly net percent price change is in column (C).

Separation of Quarterly Data into "Purchase" and "Sale" Groups

For ease of presentation of the data in table form we employ the convention that if our net purchase as a percent of total trading volume exceeded five percent for the year then the company would be classified as a "purchase" for all four quarters of that year, and if our net sales as a percent of total trading volume exceeded five percent for the year then the company would be classified as a "sale" for all four quarters of that year. A positive value for Morgan Guaranty's net trading volume as a percent of total trading volume indicates that we were a net purchaser during the quarter. However, it must be noted that for some companies we were net sellers in one or more quarters where our net purchases exceeded five percent of the total trading volume for the year, and vice versa. For example, on Table 6 we show a negative value for our net purchases as a percent of total trading volume for the first quarter of 1976 for Chemical New York Corp., indicating that we sold the company, even though it is listed in the purchase group for that quarter.

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1 Roy A. Schotland, "Bank Trust Departments and Public Policy Today," prepared for The Financial Institutions and The Nation's Economy (FINE) Study by The Committee on Banking, Currency and Housing, U.S. House of Representatives (1976) and Roy A. Schotland's Testimony before The Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Committee on Finance, U.S. Senate, June 28, 1977.

2 The percent price change for the market is subtracted out of the individual company's price change for the quarter. The Standard and Poor's 500 price index was used as a surrogate for the price performance of the market.

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MORGAN GUARANTY'S MAJOR 1975 PURCHASES: FIRST QUARTER

TABLE 1

	(A)	(B)	(C)
1	KAISER ALUM & CHEM CP	0.000	60.588
2	POTLATCH CORP	0.000	3.538
3	INCO LTD	39.948	-5.311
4	TEXTRON INC	10.438	47.798
5	CHAMPION INTL CORP	47.690	24.839
6	CROWN ZELLERBACH CORP	44.218	14.536
7	WEST POINT PEPPERELL	0.000	35.077
8	MANUFACTURERS HANOVER	9.859	-4.114
9	STEVENS J P & CO INC	4.766	-19.462
10	BURLINGTON INDS INC	41.304	36.037
11	ALUMINUM CO AMER	0.000	3.096
12	PERKIN ELMER CORP	19.717	47.813
13	TEXASGULF INC	23.760	-12.411
14	PHELPS DODGE CORP	29.800	4.906
15	STERLING DRUG INC	22.293	-31.538
16	ARMSTRONG CORK CO	16.983	-14.063
17	ILLINOIS POWER CO	0.000	6.147
18	MARSH & MCLENNAN COS	18.808	-4.545
19	GOODYEAR TIRE & RUBR	31.580	13.361
20	UNION CARBIDE CORP	3.888	15.570
21	BOISE CASCADE CORP	8.720	42.696
22	INLAND STL CO	3.324	4.191
23	MARATHON OIL CO	28.639	-27.705
24	UNITED STATES STL CORP	0.691	33.015
25	GILLETTE COMPANY	7.594	4.518
26	HERCULES INC	-0.009	-20.548
27	SPERRY RAND CORP	-0.200	4.894
28	GENERAL ELEC CO	2.608	16.238
29	GULF OIL CORP	13.510	-10.952
30	DU PONT E I DE NEMOURS	1.019	-14.138
31	STAUFFER CHEM CO	2.527	5.895
32	REYNOLDS R J INDS INC	1.052	-21.113

TABLE 2

MORGAN GUARANTY'S MAJOR 1975 PURCHASES: SECOND QUARTER

	(A)	(B)	(C)
	NAME2875BGS	PCTV2875SGS	PCTP2875SGS
1	KAISER ALUM & CHEM CP	97.837	26.027
2	POTLATCH CORP	40.474	45.236
3	INCO LTD	41.405	-2.690
4	TEXTRON INC	38.341	6.292
5	CHAMPION INTL CORP	74.011	-0.369
6	CROWN ZELLERBACH CORP	69.168	6.964
7	WEST POINT PEPPERELL	38.814	15.172
8	MANUFACTURERS HANOVER	52.981	12.256
9	STEVENS J P & CO INC	28.054	44.143
10	BURLINGTON INDS INC	29.526	-1.287
11	ALUMINUM CO AMER	36.121	17.354
12	PERKIN ELMER CORP	18.602	-9.344
13	TEXASGULF INC	26.338	1.739
14	PHELPS DODGE CORP	41.102	-8.447
15	STERLING DRUG INC	30.549	-21.167
16	ARMSTRONG CORK CO	11.875	-4.190
17	ILLINOIS POWER CO	4.298	4.096
18	MARSH & MCLENNAN COS	15.499	1.829
19	GOODYEAR TIRE & RUBR	21.481	-4.838
20	UNION CARBIDE CORP	22.871	-5.159
21	BOISE CASCADE CORP	14.622	18.419
22	INLAND STL CO	36.216	-11.085
23	MARATHON OIL CO	13.446	40.216
24	UNITED STATES STL CORP	23.794	-9.722
25	GILLETTE COMPANY	24.365	-16.534
26	HERCULES INC	14.718	17.769
27	SPERRY RAND CORP	18.833	25.882
28	GENERAL ELEC CO	16.465	0.212
29	GULF OIL CORP	13.534	2.477
30	DU PONT E I DE NEMOURS	14.961	15.066
31	STAUFFER CHEM CO	9.146	28.929
32	REYNOLDS R J INDS INC	3.357	-1.126

TABLE 3

MORGAN GUARANTY'S MAJOR 1975 PURCHASES: THIRD QUARTER

	(A)	(B)	(C)
	NAMEH75BG5	PCTV3B75G5	PCTP3B75G5
1	KAISER ALUM & CHEM CP	27.653	-16.405
2	POTLATCH CORP	54.162	4.435
3	INCO LTD	47.741	2.473
4	TEXTRON INC	61.276	-8.110
5	CHAMPION INTL CORP	-2.671	-8.824
6	CROWN ZELLERBACH CORP	13.116	1.414
7	WEST POINT PEPPERELL	31.845	11.232
8	MANUFACTURERS HANOVER	20.988	-20.790
9	STEVENS J P & CO INC	36.092	-3.899
10	BURLINGTON INDS INC	2.753	3.319
11	ALUMINUM CO AMER	11.868	-8.008
12	PERKIN ELMER CORP	17.071	-10.799
13	TEXASGULF INC	11.300	0.058
14	PHELPS DODGE CORP	-22.688	-4.723
15	STERLING DRUG INC	2.986	-8.110
16	ARMSTRONG CORK CO	3.523	-18.110
17	ILLINOIS POWER CO	34.688	0.779
18	MARSH & MCLENNAN COS	14.082	2.685
19	GOODYEAR TIRE & RUBR	-2.652	11.890
20	UNION CARBIDE CORP	10.119	3.001
21	BOISE CASCADE CORP	9.253	9.158
22	INLAND STL CO	3.538	8.276
23	MARATHON OIL CO	-0.132	7.175
24	UNITED STATES STL CORP	2.250	15.149
25	GILLETTE COMPANY	-2.137	-2.510
26	HERCULES INC	11.152	-11.157
27	SPERRY RAND CORP	13.391	-6.151
28	GENERAL ELEC CO	9.842	-4.500
29	GULF OIL CORP	-0.941	5.846
30	DU PONT E I DE NEMOURS	6.548	-4.305
31	STAUFFER CHEM CO	4.006	6.762
32	REYNOLDS R J INDS INC	16.882	5.167

TABLE 6

MORGAN GUARANTY'S MAJOR 1975 PURCHASES: FOURTH QUARTER

	(A)	(B)	(C)
	NAME8759G5	PCTV4875G5	PCTP4875G5
1	KAISER ALUM & CHEM CP	-11.174	12.460
2	POTLATCH CORP	27.528	1.071
3	INCO LTD	23.652	-7.540
4	TEXTRON INC	15.658	-6.915
5	CHAMPION INTL CORP	-0.993	23.992
6	CROWN ZELLERBACH CORP	-2.027	-6.476
7	WEST POINT PEPPERELL	54.301	-11.645
8	MANUFACTURERS HANOVER	38.576	5.081
9	STEVENS J P & CO INC	34.618	6.523
10	BURLINGTON INDS INC	-6.456	8.065
11	ALUMINUM CO AMER	20.888	-9.132
12	PERKIN ELMER CORP	23.151	-18.953
13	TEXASGULF INC	9.780	-10.578
14	PHELPS DODGE CORP	12.104	3.571
15	STERLING DRUG INC	3.624	8.866
16	ARMSTRONG CORK CO	37.639	18.438
17	ILLINOIS POWER CO	27.515	8.764
18	MARSH & MCLENNAN COS	0.538	-0.167
19	GOODYEAR TIRE & RUBR	-4.079	6.934
20	UNION CARBIDE CORP	5.703	0.866
21	BOISE CASCADE CORP	7.511	-1.360
22	INLAND STL CO	2.939	-5.665
23	MARATHON OIL CO	3.605	-21.342
24	UNITED STATES STL CORP	12.471	-4.976
25	GILLETTE COMPANY	3.025	17.226
26	HERCULES INC	3.506	4.135
27	SPERRY RAND CORP	2.314	-8.798
28	GENERAL ELEC CO	1.314	-2.711
29	GULF OIL CORP	0.084	-11.634
30	DU PONT E I DE NEMOURS	0.979	10.271
31	STAUFFER CHEM CO	5.286	7.325
32	REYNOLDS R J INDS INC	9.194	3.271

TABLE 5

MORGAN GUARANTY'S MAJOR 1975 SALES: FIRST QUARTER

	(A)	(B)	(C)
	NAMEM75SG5	PCTV1S75G5	PCTP1S75G5
1	INTERNATIONAL FLAVSFRA	-6.102	-0.378
2	BAKER INTL CORP	-21.469	-18.860
3	RALSTON PURINA CO	-6.795	-12.865
4	PHILIP MORRIS INC	-23.213	-20.548
5	MASONITE CORP	-26.822	10.784
6	SCHLUMBERGER LTD	-8.973	-17.766
7	CHESEBROUGH PONDS INC	-2.623	40.444
8	AMP INC	-7.240	15.059
9	MCDONALDS CORP	-6.470	26.921
10	SQUIBB CORP	-9.910	14.062
11	KRAFT INC	-7.867	-6.895
12	SCHLITZ JOS BREWING CO	-3.154	45.910
13	BLACK & DECKER MFG CO	-7.656	26.624
14	AMERICAN HOME PRODS CP	-0.644	-5.801
15	JOHNSON & JOHNSON	-5.071	-9.380
16	PROCTER & GAMBLE CO	-2.684	-4.105

TABLE 6

MORGAN GUARANTY'S MAJOR 1975 SALES: SECOND QUARTER

	(A)	(B)	(C)
	NAMEH75SGS	PCTV2S75GS	PCTP2S75GS
1	INTERNATIONAL FLAV&FRA	-22.718	-9.607
2	BAKER INTL CORP	-12.345	31.657
3	RALSTON PURINA CO	-10.784	-3.079
4	PHILIP MORRIS INC	-17.951	-4.138
5	MASONITE CORP	-5.709	-3.864
6	SCHLUMBERGER LTD	-16.195	2.328
7	CHESEBROUGH PONDS INC	-11.732	-6.659
8	AMP INC	-8.195	-0.014
9	MCDONALDS CORP	-16.603	16.469
10	SQUIBB CORP	-17.564	-16.754
11	KRAFT INC	-7.030	-17.628
12	SCHLITZ JOS BREWING CO	-11.936	-2.747
13	BLACK & DECKER MFG CO	-4.974	-4.552
14	AMERICAN HOME PRODS CP	-20.240	-5.748
15	JOHNSON & JOHNSON	-14.063	-6.890
16	PROCTER & GAMBLE CO	-5.089	-11.710

TABLE 7

MORGAN GUARANTY'S MAJOR 1975 SALES: THIRD QUARTER

	(A)	(B)	(C)
	NAME375SG5	PCTV3375G5	PCTP3375G5
1	INTERNATIONAL FLAV&FRA	-19.499	-14.405
2	BAKER INTL CORP	-2.327	11.690
3	RALSTON PURINA CO	-30.374	2.723
4	PHILIP MORRIS INC	-8.640	-0.991
5	MASONITE CORP	-9.356	-15.696
6	SCHLUMBERGER LTD	-6.922	-5.208
7	CHESEBROUGH PONDS INC	-34.712	-10.094
8	AMP INC	-7.274	-12.942
9	MCDONALDS CORP	-9.848	-6.531
10	SQUIBB CORP	-1.715	-7.189
11	KRAFT INC	-22.609	6.065
12	SCHLITZ JOS BREWING CO	-5.732	-24.717
13	BLACK & DECKER MFG CO	-10.665	-20.344
14	AMERICAN HOME PRODS CP	-3.201	-11.164
15	JOHNSON & JOHNSON	-8.913	-6.980
16	PROCTER & GAMBLE CO	-4.443	-3.524

TABLE 8

MORGAN GUARANTY'S MAJOR 1975 SALES: FOURTH QUARTER

	(A)	(B)	(C)
	NAME875SG5	PCTV4S75G5	PCTP4S75G5
1	INTERNATIONAL FLAVEFRA	-14.396	-3.756
2	BAKER INTL CORP	-18.264	-18.474
3	RALSTON PURINA CO	-6.216	8.362
4	PHILIP MORRIS INC	-5.612	6.438
5	MASONITE CORP	-0.086	-4.139
6	SCHLUMBERGER LTD	-9.009	-2.167
7	CHESEBROUGH PONDS INC	-2.196	11.911
8	AMP INC	-12.932	-12.897
9	MCDONALDS CORP	-9.138	17.998
10	SQUIBB CORP	-0.865	0.590
11	KRAFT INC	-0.045	9.298
12	SCHLITZ JOS BREWING CO	-2.168	0.206
13	BLACK & DECKER MFG CO	-9.107	-7.000
14	AMERICAN HOME PRODS CP	-0.957	-3.649
15	JOHNSON & JOHNSON	-1.851	6.068
16	PROCTER & GAMBLE CO	-12.379	-0.311

TABLE 9

MORGAN GUARANTY'S MAJOR 1976 PURCHASES: FIRST QUARTER

	(A)	(B)	(C)
	NAMEMGT50B	PCTV18	PCTP18
1	CINCINNATI MILACRON	23.462	48.888
2	CONTINENTAL CORP	17.205	0.050
3	SOUTHERN RY CO	11.866	-2.728
4	PITTSTON CO	11.710	-1.065
5	AMERICAN STD INC	23.567	45.005
6	CHEMICAL NEW YORK CORP	-6.535	10.843
7	ARA SVCS INC	19.384	3.758
8	NATIONAL STL CORP	17.523	8.747
9	ALLIS CHALMERS CORP	14.697	26.675
10	BORG WARNER CORP	2.225	28.550
11	ROYAL DUTCH PETE CO	0.015	-2.377
12	BURLINGTON NORTHN INC	12.208	0.503
13	UAL INC	8.027	-30.250
14	DEERE & CO	5.596	8.701
15	TEXTRON INC	31.547	24.559
16	SANTA FE INDS INC	5.741	16.503
17	AIRCO INC	23.683	33.568
18	NORFOLK & WESTN RY CO	12.266	6.794
19	TEKTRONIX INC	4.008	19.755
20	ALLIED STORES CORP	3.310	9.274
21	REYNOLDS R J INDS INC	11.084	-12.731
22	EATON CORP	0.594	6.218
23	MISSOURI PAC CORP	9.406	36.593
24	COLT INDS INC DEL	9.295	48.932
25	FIRESTONE TIRE&RUBBER	8.394	-9.456
26	REYNOLDS METALS CO	2.516	61.756
27	SCOTT PAPER CO	19.691	44.170
28	MEAD CORP	5.039	44.269
29	INLAND STL CO	9.262	9.363
30	INTERNATIONAL TEL&TELE	2.774	12.161
31	SOUTHERN PAC CO	11.792	9.804
32	SHELL OIL CO	-0.011	-3.236
33	UNION PAC CORP	0.078	-3.805
34	BETHLEHEM STL CORP	5.156	14.187
35	GENERAL ELEC CO	2.332	-0.129
36	ALUMINUM CO AMER	5.291	11.616
37	PPG INDS INC	0.765	15.732
38	BOEING CO	0.000	-3.694
39	TENNECO INC	-0.943	-8.343
40	SMITHKLINE CORP	3.239	0.880
41	MINNESOTA MNG & MFG CO	3.405	1.591

TABLE 10

MORGAN GUARANTY'S MAJOR 1976 PURCHASES: SECOND QUARTER

	(A)	(B)	(C)
	NAMEMGT50B	PCTV2B	PCTP2B
1	CINCINNATI MILACRON	62.906	14.713
2	CONTINENTAL CORP	14.431	-5.229
3	SOUTHERN RY CO	35.323	5.032
4	PITTSTON CO	15.009	29.244
5	AMERICAN STD INC	20.116	-8.043
6	CHEMICAL NEW YORK CORP	28.136	6.477
7	ARA SVCS INC	12.146	-7.222
8	NATIONAL STL CORP	12.192	8.986
9	ALLIS CHALMERS CORP	6.899	36.308
10	BORG WARNER CORP	29.586	-4.979
11	ROYAL DUTCH PETE CO	15.836	-0.938
12	BURLINGTON NORTHN INC	18.203	24.127
13	UAL INC	16.645	15.372
14	DEERE & CO	12.541	7.764
15	TEXTRON INC	10.436	2.566
16	SANTA FE INDS INC	18.174	-4.940
17	AIRCO INC	4.358	24.972
18	NORFOLK & WESTN RY CO	9.514	5.823
19	TEKTRONIX INC	21.466	5.197
20	ALLIED STORES CORP	7.587	-14.330
21	REYNOLDS R J INDS INC	7.461	-10.908
22	EATON CORP	8.828	15.313
23	MISSOURI PAC CORP	12.410	-3.997
24	COLT INDS INC DEL	9.388	13.275
25	FIRESTONE TIRE&RUBBER	10.174	-2.545
26	REYNOLDS METALS CO	11.150	-4.685
27	SCOTT PAPER CO	2.686	-7.958
28	MEAD CORP	12.101	6.322
29	INLAND STL CO	10.266	9.973
30	INTERNATIONAL TEL&TELE	7.611	-1.470
31	SOUTHERN PAC CO	9.715	-9.497
32	SHELL OIL CO	11.061	19.728
33	UNION PAC CORP	8.816	6.571
34	BETHLEHEM STL CORP	12.003	6.542
35	GENERAL ELEC CO	7.164	7.339
36	ALUMINUM CO AMER	5.563	15.025
37	PPG INDS INC	7.615	17.604
38	BOEING CO	9.854	50.158
39	TENNECO INC	-0.693	11.362
40	SMITHKLINE CORP	13.534	2.773
41	MINNESOTA MNG & MFG CO	17.824	-14.725

TABLE 11

MORGAN GUARANTY'S MAJOR 1976 PURCHASES: THIRD QUARTER

	(A)	(B)	(C)
	NAMEDGT50B	PCTV3B	PCTP3B
1	CINCINNATI MILACRON	40.432	-10.206
2	CONTINENTAL CORP	13.372	10.018
3	SOUTHERN RY CO	1.737	-3.657
4	PITTSTON CO	15.836	-15.128
5	AMERICAN STD INC	-1.688	13.150
6	CHEMICAL NEW YORK CORP	34.980	-4.601
7	ARA SVCS INC	0.759	-8.432
8	NATIONAL STL CORP	1.272	-10.143
9	ALLIS CHALMERS CORP	11.513	14.134
10	BORG WARNER CORP	4.893	3.171
11	ROYAL DUTCH PETE CO	14.914	-2.772
12	BURLINGTON NORTHN INC	3.320	-7.965
13	UAL INC	5.651	-8.578
14	DEERE & CO	12.241	-9.553
15	TEXTRON INC	-6.367	1.666
16	SANTA FE INDS INC	7.177	-10.397
17	AIRCO INC	-4.995	-8.905
18	NORFOLK & WESTN RY CO	4.593	7.388
19	TEKTRONIX INC	3.445	-0.920
20	ALLIED STORES CORP	11.398	-10.335
21	REYNOLDS R J INDS INC	6.204	9.945
22	EATON CORP	18.667	1.475
23	MISSOURI PAC CORP	7.537	6.487
24	COLT INDS INC DEL	3.173	-15.406
25	FIRESTONE TIRE&RUBBER	4.758	1.254
26	REYNOLDS METALS CO	5.173	2.734
27	SCOTT PAPER CO	-1.080	-3.434
28	MEAD CORP	9.267	-12.968
29	INLAND STL CO	2.265	-11.188
30	INTERNATIONAL TEL&TELE	8.243	11.415
31	SOUTHERN PAC CO	2.264	-4.556
32	SHELL OIL CO	9.700	12.388
33	UNION PAC CORP	10.203	-7.145
34	BETHLEHEM STL CORP	12.320	-12.459
35	GENERAL ELEC CO	11.175	-6.172
36	ALUMINUM CO AMER	2.002	5.275
37	PPG INDS INC	5.663	-13.506
38	BOEING CO	4.082	11.657
39	TENNECO INC	9.963	4.962
40	SMITHKLINE CORP	4.348	14.478
41	MINNESOTA MNG & MFG CO	-0.425	14.810

TABLE 12

MORGAN GUARANTY'S MAJOR 1976 PURCHASES: FOURTH QUARTER

	(A)	(B)	(C)
	NAMEHGT508	PCTV48	PCTP48
1	CINCINNATI MILACRON	19.001	6.945
2	CONTINENTAL CORP	20.831	0.707
3	SOUTHERN RY CO	10.326	5.249
4	PITTSTON CO	16.130	-11.346
5	AMERICAN STD INC	-2.020	-1.670
6	CHEMICAL NEW YORK CORP	0.670	7.126
7	ARA SVCS INC	10.801	-0.587
8	NATIONAL STL CORP	7.162	-5.586
9	ALLIS CHALMERS CORP	7.170	-4.914
10	BORG WARNER CORP	5.293	4.440
11	ROYAL DUTCH PETE CO	11.271	10.826
12	BURLINGTON NORTHN INC	1.709	0.814
13	UAL INC	6.887	2.768
14	DEERE & CO	6.941	-2.504
15	TEXTRON INC	-5.159	-9.673
16	SANTA FE INDS INC	0.993	11.969
17	AIRCO INC	6.148	-0.044
18	NORFOLK & WESTN RY CO	4.872	3.748
19	TEKTRONIX INC	4.565	4.921
20	ALLIED STORES CORP	14.580	1.261
21	REYNOLDS R J INDS INC	6.588	6.090
22	EATON CORP	3.111	0.522
23	MISSOURI PAC CORP	-1.401	10.649
24	COLT INDS INC DEL	3.103	17.016
25	FIRESTONE TIRE&RUBBER	1.394	-1.046
26	REYNOLDS METALS CO	17.233	0.454
27	SCOTT PAPER CO	-3.602	1.640
28	MEAD CORP	0.072	11.589
29	INLAND STL CO	2.162	-0.866
30	INTERNATIONAL TEL&TELE	8.277	4.165
31	SOUTHERN PAC CO	0.497	6.192
32	SHELL OIL CO	0.522	3.762
33	UNION PAC CORP	6.138	16.216
34	BETHLEHEM STL CORP	5.809	-1.799
35	GENERAL ELEC CO	3.823	0.661
36	ALUMINUM CO AMER	9.748	-6.693
37	PPG INDS INC	10.149	18.309
38	BOEING CO	4.742	-4.562
39	TENNECO INC	14.018	6.779
40	SMITHKLINE CORP	2.060	-4.717
41	MINNESOTA MNG & MFG CO	-2.259	-14.149

TABLE 13

MORGAN GUARANTY'S MAJOR 1976 SALES: FIRST QUARTER

	(A)	(B)	(C)
	NAMEMGTSOS	PCTV1S	PCTP1S
1	DILLON COS INC	-36.740	-0.942
2	GENUINE PARTS CO	-19.430	-9.826
3	ECHLIN MFG CO	-13.579	-3.312
4	KNIGHT RIDDER NEWSPPRS	-2.772	12.973
5	RICHARDSON MERRELL INC	-6.796	-13.448
6	SKAGGS COS INC	-17.612	12.300
7	DUN & BRADSTREET COS	-10.116	-14.827
8	EMERY AIR FGHT CORP	-5.538	-22.506
9	LUBRIZOL CORP	-2.917	-14.902
10	GANNETT INC	-7.329	-8.487
11	BAKER INTL CORP	-16.966	-25.971
12	NATIONAL CHEMSEARCH CP	-17.860	-19.097
13	COCA COLA BOTTLING N Y	-6.676	-1.881
14	INTERNATIONAL FLAV&FRA	-3.648	-4.575
15	MARSH & MCLENNAN COS	-7.321	-22.963
16	ENVIROTECH CORP	-10.398	30.805
17	CONSOLIDATED FREIGHTWY	-8.192	14.909
18	LOWES COS INC	-14.419	-13.950
19	CUMMINS ENGINE INC	-0.401	49.512
20	AMP INC	-13.470	3.975
21	ECKERD JACK CORP	-0.266	-1.950
22	AMERICAN HOME PRODS CP	-6.587	-7.208
23	FIRST INTL BANCSHARES	-0.080	6.320
24	BURLINGTON INDS INC	-3.111	-7.644
25	CHESEBROUGH PONDS INC	-5.153	-13.950
26	SCHLUMBERGER LTD	-6.142	-10.990
27	GILLETTE COMPANY	-12.064	-16.572
28	HALLIBURTON CO	-7.523	-10.702
29	MCDONALDS CORP	-5.001	-4.314
30	HERCULES INC	-8.607	11.505
31	DISNEY WALT PRODTNS	-10.177	7.854
32	PERKIN ELMER CORP	-1.337	11.817
33	RALSTON PURINA CO	-7.861	-11.575

TABLE 14

MORGAN GUARANTY'S MAJOR 1976 SALES: SECOND QUARTER

	(A)	(B)	(C)
	NAMEHGT50S	PCTV2B	PCTP2S
1	DILLON COS INC	-40.569	-15.139
2	GENUINE PARTS CO	-46.887	-1.470
3	ECHLIN MFG CO	-30.131	-11.085
4	KNIGHT RIDDER NEWSPPRS	-11.133	-6.877
5	RICHARDSON MERRELL INC	-29.053	-6.470
6	SKAGGS COS INC	-9.735	-14.341
7	DUN & BRADSTREET COS	-13.857	-2.797
8	EMERY AIR FGHT CORP	-23.124	3.208
9	LUBRIZOL CORP	-20.476	0.453
10	GANNETT INC	-19.557	2.002
11	BAKER INTL CORP	-16.093	10.739
12	NATIONAL CHEMSEARCH CP	-6.040	-22.013
13	COCA COLA BOTTLING N Y	-21.397	0.068
14	INTERNATIONAL FLAV&FRA	-15.205	-5.280
15	MARSH & MCLENNAN COS	-8.306	7.492
16	ENVIROTECH CORP	0.000	29.931
17	CONSOLIDATED FREIGHTWY	-7.304	-1.991
18	LOWES COS INC	-6.572	-14.932
19	CUMMINS ENGINE INC	-7.087	22.059
20	AMP INC	0.395	4.930
21	ECKERD JACK CORP	-11.970	-17.541
22	AMERICAN HOME PRODS CP	-12.478	-5.330
23	FIRST INTL BANCSHARES	-4.620	1.901
24	BURLINGTON INDS INC	-9.606	-15.877
25	CHESEBROUGH PONDS INC	-6.827	-5.019
26	SCHLUMBERGER LTD	-14.764	9.722
27	GILLETTE COMPANY	-0.900	-5.316
28	HALLIBURTON CO	-8.648	24.937
29	MCDONALDS CORP	-4.307	-10.064
30	HERCULES INC	-4.380	-7.992
31	DISNEY WALT PRODTNS	-4.752	-8.260
32	PERKIN ELMER CORP	-4.001	-9.763
33	RALSTON PURINA CO	-3.912	4.973

TABLE 15

MORGAN GUARANTY'S MAJOR 1976 SALES· THIRD QUARTER

	(A)	(B)	(C)
	NAMEHGT50S	PCTV33	PCTP35
1	DILLON COS INC	-41.585	16.334
2	GENUINE PARTS CO	-20.690	-2.240
3	ECHLIN MFG CO	-38.359	3.667
4	KNIGHT RIDDER NEWSPPRS	-36.273	5.969
5	RICHARDSON MERRELL INC	-16.744	12.764
6	SKAGGS COS INC	-15.305	9.307
7	DUN & BRADSTREET COS	-10.803	-3.611
8	EMERY AIR FGHT CORP	-1.039	-18.238
9	LUBRIZOL CORP	-11.335	-4.065
10	GANNETT INC	-14.535	4.449
11	BAKER INTL CORP	-2.029	11.515
12	NATIONAL CHEMSEARCH CP	-9.074	-14.091
13	COCA COLA BOTTLING N Y	-14.439	-8.496
14	INTERNATIONAL FLAV&FRA	-12.029	-3.890
15	MARSH & MCLENNAN COS	-4.626	2.976
16	ENVIROTECH CORP	-11.962	0.918
17	CONSOLIDATED FREIGHTWY	-17.054	12.169
18	LOWES COS INC	-6.949	-1.872
19	CUMMINS ENGINE INC	-15.905	14.636
20	AMP INC	-4.820	3.215
21	ECKERD JACK CORP	0.000	10.250
22	AMERICAN HOME PRODS CP	-7.402	2.000
23	FIRST INTL BANCSHARES	-16.473	-15.594
24	BURLINGTON INDS INC	-13.400	4.525
25	CHESEBROUGH PONDS INC	-22.378	-9.145
26	SCHLUMBERGER LTD	-3.927	14.023
27	GILLETTE COMPANY	-5.134	-8.920
28	HALLIBURTON CO	-1.280	5.563
29	MCDONALDS CORP	-4.611	-6.889
30	HERCULES INC	-6.900	-9.835
31	DISNEY WALT PRODTNS	-3.695	-16.373
32	PERKIN ELMER CORP	-8.761	-4.643
33	RALSTON PURINA CO	-2.432	-2.131

TABLE 16

MORGAN GUARANTY'S MAJOR 1976 SALES: FOURTH QUARTER

	(A)	(B)	(C)
	NAMEMGT50S	PCTV45	PCTP45
1	DILLON COS INC	-2.218	-9.715
2	GENUINE PARTS CO	-14.990	-1.776
3	ECHLIN MFG CO	-7.269	11.596
4	KNIGHT RIDDER NEWSPPRS	-16.549	2.312
5	RICHARDSON MERRELL INC	-2.147	-6.740
6	SKAGGS COS INC	-1.889	-8.296
7	DUN & BRADSTREET COS	-15.065	10.332
8	EMERY AIR FGHT CORP	-11.233	-1.097
9	LUBRIZOL CORP	-11.761	-8.604
10	GANNETT INC	-5.745	0.756
11	BAKER INTL CORP	-2.612	-19.161
12	NATIONAL CHEMSEARCH CP	-12.623	0.699
13	COCA COLA BOTTLING N Y	-0.029	7.728
14	INTERNATIONAL FLAV&FRA	-11.773	-11.804
15	MARSH & MCLENNAN COS	-11.987	-7.527
16	ENVIROTECH CORP	-11.234	-3.193
17	CONSOLIDATED FREIGHTWY	-4.760	-3.962
18	LOWES COS INC	-3.007	13.275
19	CUMMINS ENGINE INC	-6.463	4.483
20	AMP INC	-9.312	-20.522
21	ECKERD JACK CORP	-15.363	8.416
22	AMERICAN HOME PRODS CP	-3.573	-11.330
23	FIRST INTL BANCSHARES	-14.119	8.399
24	BURLINGTON INDS INC	-3.439	4.463
25	CHESEBROUGH PONDS INC	5.187	-7.770
26	SCHLUMBERGER LTD	-1.754	-5.735
27	GILLETTE COMPANY	1.060	-5.153
28	HALLIBURTON CO	-1.366	-5.985
29	MCDONALDS CORP	-7.256	-5.285
30	HERCULES INC	-0.230	-6.791
31	DISNEY WALT PRODTNS	-2.541	-0.455
32	PERKIN ELMER CORP	-8.288	-9.292
33	RALSTON PURINA CO	-4.665	2.057

Means and Standard Deviations for Net Price Change of The Purchase and Sale Groups
For 1975 and 1976 by Quarter - in Percent

	1975				1976			
	1st Q	2nd Q	3rd Q	4th Q	1st Q	2nd Q	3rd Q	4th Q
Purchase								
Mean	5.84	7.32	-1.79	-.97	14.48	6.36	-1.93	2.50
Standard Deviation	23.15	16.98	9.19	9.94	20.05	13.74	9.32	6.91
Sample Size	25	32	26	27	37	41	36	38
Sale								
Mean	3.75	-2.68	-5.01	2.54	-2.73	-2.83	.18	-2.39
Standard Deviation	20.80	12.05	9.81	10.14	15.40	10.91	9.71	8.50
Sample Size	18	16	22	21	36	32	37	36

Note: To be classified a "purchase" we must have been a net purchaser of shares in the quarter, to be classified a "sale" we must have been a net seller of shares in the quarter. The standard deviation is calculated by dividing the sum of squared deviations from the mean by n (the number of observations in the sample) minus 1.

Mr. SMITH. Another point I would like to make is that it is important to realize that when the size of the market is taken into account, we are not as big as we at first appear. For instance, the total value of the securities managed by our division for all kinds of accounts is less than 1 percent of all United States financial assets, and the total value of the equities which we manage for all accounts is slightly less than 2 percent of the total value of all American equities.

In 1975, our trading in equities accounted for less than 3 percent of total transaction volume, and in 1976 the figure was lower. Professor Schotland, whose article was referred to by the chairman in the course of introducing S. 285, cited instances in which our division's trading accounted during a particular period for a substantial portion of the total trading in a security and then stated that "it defies belief" that such trading did not have a significant impact on price movements.

To the contrary, the analysis I referred to earlier, also attached to our statement, shows quite clearly that there was virtually no discernible relationship between our share of the trading in the stocks Professor Schotland mentioned and the movement of those shares' prices. This should not be surprising in light of the fact that it is very much in our own self-interest to minimize price impact since the performance of our clients' accounts is helped if we buy at the lowest possible price and sell at the highest possible prices.

The last of the misconceptions to which I would draw your attention concerns the possibility that large pension managers will eventually achieve too much control over the economy through holdings in pension trusts. Speaking for Morgan Guaranty, I can assure your committee that investments are made for investment reasons and not for control, and that we have procedures to avoid situations which could put the division in the position of a controlling shareholder within the meaning of the various securities laws and regulations.

Now I should like to talk about the ways in which S. 285, if adopted, would be counterproductive. In general, I feel that the bill's provisions are an attempt to substitute arbitrary measures for the interplay of independent financial analyses and judgments by numerous market participants acting on their own behalf or on the behalf of many different clients. Such interference with the capital allocation process can only make markets less efficient and must work to the detriment of companies seeking to raise capital and investors seeking to invest rationally.

Has the committee considered how many companies' stocks would be instantaneously subjected by the bill to inefficiencies in the market's pricing? One cannot tell from existing data the number of companies in which a pension manager owns over 5 percent of the outstanding shares. However, the Comptroller of the Currency's data indicates that there are 180 companies which have at least one large institutional holder of 5 percent or more of the outstanding shares. In effect, the respective pension managers holding 5 percent of these stocks could make only one portfolio action decision—that is, to sell—no matter how attractive the outlook for the stock appeared to be.

Clearly, this would produce a negative drag on the market for those shares, making the raising of equity capital more difficult and costly for those companies. The resulting inefficiency is far from trivial when one considers that the group of literally "one decision" stocks, which S. 285 would create would be at least three times as large as the so-called "nifty 50" which at one time was of major concern. I would note that the market's ability to work its way out of the two-tier pattern of the early 1970's without legislation further illustrates the efficiency of the free market in achieving self-correction.

Ironically, the arbitrary 5 percent limitation would not necessarily result in better diversification. Should the law encourage new money flows to go to smaller investment institutions, there is no guarantee this money will be invested in the shares of corporations the legislation seeks to help. In fact, as discussed previously, the available evidence suggests that transferring assets from larger to smaller institutions will actually diminish diversification.

An extraordinary feature of the bill is that its avowed intention is to slow or reverse the growth of those institutional investment managers who have been most successful in attracting business. Morgan Guaranty, since it is one of the largest and most successful investment managers, is intended as a target of S. 285. It is indicative of the competitive vigor of the investment field that our equity holdings account for somewhat less than 2 percent of the total value of American equity securities. And, as I also noted earlier, the assets we hold represent less than 1 percent of all American financial assets.

I cannot stress too strongly the fact that our pension business is in no sense tied to us in the intensely competitive market for investment management services. Each one of our pension plans permits the sponsoring organization to hire and fire trustees at will. These changes are frequent and involve large sums of money. An investment organization that fails to perform will soon find itself facing a very substantial shrinkage in the amount of assets under management.

To suggest punishing precisely those investment managers who have been successful in attracting and managing pension plans would be a disservice not only to those in the business of investment management, but especially to those beneficiaries whose retirement incomes are to be funded from the plans we manage.

We believe that S. 285 might well inhibit our ability to produce the best investment results we are capable of, and we can see no public good to be served from so hobbling our efforts and those of other managers of private pension funds.

Thank you for this opportunity to present our views. I would be glad to respond now to questions you might have, particularly concerning S. 285.

Senator BENTSEN. Thank you very much, Mr. Smith. We appreciate your testimony.

Mr. Schotland has testified that the big 7, 6 of which are in New York City alone, manage two-fifths of all pension trust accounts. Would it concern you if they managed four-fifths of all pension trust accounts? Do you think that that would be a healthy thing for our country?

They now manage two-fifths, seven of them, and if they were concentrated to the point that they managed four-fifths?

Mr. SMITH. Mr. Chairman, I believe that the thrust of your question ignores the very substantial differences in opinion, methods and results of the large trust companies in New York. They are not at all monolithic in what they do. In fact, they tend, very often, to act in opposite directions.

Senator BENTSEN. Would you mind answering me whether you think it would be good or not if they went from two-fifths to four-fifths?

Mr. SMITH. It would not bother me, as long as their method of management and their results are as diverse as they are at the present time.

Senator BENTSEN. Do you think there is any advantage at all to regional diversification in the thought process of investments, the local knowledge of local situations?

Mr. SMITH. Yes, I do. I think that regional investment firms, including investment banking firms like the 11 that we deal with in the southwest, can provide a great deal to the more efficient functioning of the economy and regional trust companies can also have a more intimate knowledge of the companies in their area.

That is not to say that the investments of large trust companies like ourselves are at all parochial or limited to the Northeast. The contrary is true.

Senator BENTSEN. I noted your comments, that the portfolio managers do not have an excessive amount, or go beyond the 5 percent, with an idea of controlling the company. I think that is true in the vast, vast majority of instances, and I have listened to stories about there being a wall between the trust department and the commercial section of the bank. But in many instances, I think that is a pretty leaky wall—a Chinese wall.

Look at the situation, as I recall—I think it was Leasco—making a bid on Chemical, and all of a sudden the walls came tumbling down and it became very apparent that the commercial side of the bank had full knowledge of what the trust side of the bank had in the number of shares of Leasco, and there was a question of whether that was taken advantage of.

I question whether that was for the benefit of the pension recipients. Look at a situation where a major bank trust department has very substantial holdings in a major oil company, and the head of that oil company sat on the board of directors of that bank. I cannot help but have the hunch that he understood that the trust department of that bank had major holdings of stocks in his company.

This leads me to the conclusion that, even though that wall is there, it is what is happening on the other side of that wall. It does give me concern. Sometimes when we talk about not having a major effect on the stock's price, the numbers may not show a major effect, but just holding the price can be a major impact in influencing its price.

Several years ago, a Federal judge imposed a fine on IBM down in Oklahoma on antitrust violations. In 2 days, the value of that stock dropped 37 points. Over the weekend, the judge thought better of it, and modified his opinion and stated what he really meant, and the price recuperated.

Does that not indicate that pension managers should be very careful about excessively large holdings in stocks, even in very large companies?

Mr. SMITH. Could I ask whether I could make a comment on what you said about the Chinese wall?

Senator BENTSEN. Yes.

Mr. SMITH. It was not in the form of a question, but I would like the opportunity to say, speaking for ourselves alone, although we never had a crisis situation similar to the Leasco incident, and I do not believe we ever will, the Chinese wall is a reality.

I think it would be an interesting exercise, if not probably a futile one, to look at the members of our board of directors and the activities of the stocks in their companies while they sit on the board. I think it would reveal no correlation at all.

The fact is the communication between the Trust and Investment Division on 57th Street and the Commercial Bank at 23 Wall Street is very effectively controlled and the Chinese wall is a reality in our life, not at all leaky.

I regret to say that I have forgotten what your question actually was.

Senator BENTSEN. My question was on IBM.

Mr. SMITH. If we have a fault in our trading practices, and I am sure we do, it is not in jumping the gun and reacting very quickly to news events. It is our custom to analyze them thoroughly, perhaps to death, on some occasions.

It is very unlikely that we would be acting as precipitously as whoever it was who made those sales of IBM in the incident that you quoted.

Senator BENTSEN. Do you not think it is a problem if, over a year's time, that it takes you a year to produce a holding and you are selling every day that the stock is traded except 12? That puts a limitation on it, in trying to represent your pension holder.

Mr. SMITH. It is a characteristic, for better or worse, of our style of investing that our turnover in equities is relatively low as compared to institutional managers as a class.

Senator BENTSEN. Is that not a characteristic of a very large holding, and you are deeply concerned about depressing the price and having illiquidity as far as making an expeditious sale of the stock?

Mr. SMITH. In the cases where we have been making substantial sales in the last 3 years, we do not feel that there is any hurry at all. It is a question of over-representation in individual accounts. In the case of Schlumberger for instance, one of our largest and most successful holdings, we have been reducing our holdings. The stock has continued to rise. That is true of IBM.

There is no element in crisis of any of those decisions.

Senator BENTSEN. Is there a situation where, once you have made the decision, it is wise to reduce it? Are you not in a position where you are penalized by the size of your holdings?

Mr. SMITH. That would be most likely not in very liquid stocks like IBM, particularly ones that provide opportunities.

Senator Bentsen. Even though it took a year on IBM?

Mr. SMITH. That is correct. A year is not very long in our life. It is more likely to happen——

Senator BENTSEN. It may be a long time in a pensioner's life.

Mr. SMITH. It is more likely to happen in the smaller and medium-sized companies with less liquid markets, particularly these days with the contraction of the street you mentioned in your statement.

That is the danger in investing in small companies and is one reason why the research effort has to be very good.

Senator BENTSEN. Do you believe that you are so necessarily different from the insurance companies with the 5 percent limitation in the State of New York that affects the major life insurance companies of this country, that they are able to operate under that but you could not?

Mr. SMITH. The life insurance companies that we are essentially talking about, the rules on their investing their own funds, so to speak, or in the case of mutual funds——

Senator BENTSEN. You are talking about the policyholders funds.

Mr. SMITH. That is right. Not funds held for clients, as in separate accounts.

In any case, while it would be possible, certainly, for us to live with the 5 percent limitation I think that it would have bad, rather than good effects. It may have had those effects in the case of insurance companies. I am not sure.

Mr. SCHOTLAND. Mr. Chairman, may I have a moment to make one or two points?

Senator BENTSEN. Yes.

Mr. SCHOTLAND. First: I am puzzled by Mr. Smith's overlooking the fact that the insurance companies do manage money for persons other than policyholders. I guess if you manage $19 billion equities as the Morgan does you forget that there is an entire industry out there that manages only $19 billion in equities, the very figure that all life insurers combined manage for *pension* accounts.

This points up one of the flaws both in the Morgan's statements this morning and the studies to which they point, the flaw of aggregating. For example, they say they have only 2 percent of all equities. They have as much in equities as the entire life insurance industry has for pension plans. They, alone, have half as much in equities as the entire investment company industry put together.

They say they only do 3 percent of all the transactions, but my studies show that in just NYSE-listed stocks and only big ones at that, the Morgan has accounted for over 20 percent of the year's total trading in 20 different instances over the last 4 years. Consider: In 1975, they bought 39 percent of all volume in Kaiser Aluminum; 31 percent in International Nickel, and 25 percent in Nickel the year before. In 1975, they bought 24 percent of all the trading in Manufacturers Hanover, and in 1976, 13 percent of all the trading in Chemical Bank. Those are both New York City banks.

Two: on the Chinese wall, I had the pleasure of addressing the American Bankers' Association Trust Division on the Chinese wall back in the autumn, with a representative of Citibank and a representative of a San Antonio bank. After Citibank set forth the kind of incredible care and thoroughness with whch they do erect a wall, I am sure the same kind of thing that Morgan and some of the others have done—I thought the San Antonio gentleman put it perfectly when he said, "We cannot afford a second dining room; we do not even have a first dining room."

The wall may be quite impervious, actually, at the most giant banks although there are crisis situations like Leasco. On the other hand, there are some major banks—I know of a major west coast bank, which I will not name—and saying that, I need to say it is not the Bank of America—where the committee selecting stocks consisted one-half of officers from the commercial side. That is within the past 3 years. Even if the wall is absolutely gorgeous at a few banks, there are a few others where we may have some problems.

A 5-percent holding limit is not an answer to the "wall" problems. What it does do is reduce the incentive to abuse, to take advantage of, any conflicts.

Just two other points. The Morgan accurately points out their exemplary diversification, but in making that very point they are showing how undiversified, how much thoroughly less diversified, are the others. The question is not whether this legislation ought to change the Morgan. The question is whether it ought not make the best practice of the best of the banks a more general practice.

One last point. They say they show there are not price impacts, but they say "overall," for example, the institutional investment study which they quote, "institutional trading overall has not impaired price stability."

That is like looking at the whole population of America and saying that because there are 220 million people and probably not even 1 million are affected by crime, we have no crime problem.

There are particular stocks that are severely impacted by heavy trading, with prices distorted upward or downward.

At the very last, I was quite struck that one of the studies Morgan appends to its very good statement this morning, an article by one Mr. Reilly, says on page 8:

> Even if a stock is actively traded, an attempt to sell a substantial percent of the outstanding stock will cause a significant price adjustment. Therefore, for their own protection, institutions will normally not own more than 5 percent of even the most active stocks.

Senator BENTSEN. Thank you, Professor Schotland.

Let me touch on another point—the prudent man rule—and I want to look at what you have recommended.

I am concerned that the prudent man rule has inadvertently discouraged investments in new and expanding smaller companies and, at some point, you have a line—I do not know where that is—between venture capital and something that is more stable. I guess it is a matter of judgment, almost.

I do not believe venture capital is just limited to the first issue. Sixty-four percent of the pension trustees surveyed by the International Foundation of Employee Benefit Plans, in 1976 reported that, as a result of the 1974 Pension Reform Act that they were less willing to invest in anything other than blue chip-type investments.

I do not know if the pension trustees are correct or not in their interpretation and I get lawyers on both side of the line before us as to what that prudent man rule really means.

What happens is the portfolio manager says, if there is a question, then I will do what will keep me from being criticized and I will just go into the blue chips. Too often, I think that is the reaction that we get. I proposed a 2-percent limitation and some people are afraid of that. I would frankly be delighted if we could get a prudent man rule of a portfolio rather than an individual stock approach. I assume, perhaps, that is something in line with the recommendations you are making. I have not had a chance to study them.

If we could rewrite the prudent man rule where ~~we could~~ get across the true intent, I would be very interested in doing that.

Would you like to comment on that?

Mr. SMITH. I would be glad to.

Perhaps I am inclined to put too much emphasis on the fact that we do not feel that a modification in the Federal prudent man rule is necessary for our own operation. That is probably because we have been investing in small companies for a long time under the New York prudent man rule and we feel comfortable doing it.

I must say that your survey was rather compelling. One has to take seriously the attitudes of these people. Perhaps some of them are thinking of investing in small companies for the first time. If they are actually being discouraged by the working in the Federal prudent man rule, they could not be discouraged by the legislative history behind it.

If they are discouraged by the wording, I think it is very reasonable to do what can be done to remove some of those fears and I think a change such as the simple one that we recommend is preferable to the 2 percent that was originally in your bill.

Senator BENTSEN. What we are seeking is a way to encourage these pension funds to give some consideration to the newer and smaller companies and we certainly are amenable to recommendations and suggestions to accomplish that same suggestion that I think we should share.

Professor Schotland, do you have further comment?

Mr. SCHOTLAND. I agree entirely with what Mr. Smith has said.

Senator BENTSEN. I will leave you in agreement on that point. Thank you.

[The prepared statement of Mr. Smith follows. Oral testimony continues p. 340.]

STATEMENT OF HARRISON V. SMITH, EXECUTIVE VICE PRESIDENT, MORGAN GUARANTY TRUST COMPANY OF NEW YORK

Mr. Chairman and members of the committee: My name is Harrison V. Smith. I am an Executive Vice President of Morgan Guaranty Trust Company of New York and head of its Trust and Investment Division. I welcome this opportunity to appear before you to present our views on S. 901 and S. 285.

Morgan Guaranty's Trust and Investment Division manages assets which were valued on March 31, 1977 at approximately $24 billion. Of this amount, approximately $14 billion of assets were in trusts for some 600 pension and other employee benefits plans.

The Division recently published its annual report describing in considerable detail the composition of assets under management, comparisons of performance and annual activity rates, major transactions, and equity holdings with a market value exceeding $1 million. This report, like its five predecessors beginning in 1972, was prepared voluntarily and distributed in an effort to dispel any mystery about our activities. Copies are included with my statement for the Committee's use.

The Trust and Investment Division is a specialized, essentially separate activity of Morgan Guaranty. Its survival rests on the investment and administrative services provided to meet the individual circumstances of a large number of clients. We are very conscious that the purpose of the pension plans for which we are trustee is to help fund the retirement needs of at least 3 million Americans. Since meeting these fiduciary responsibilities is the cornerstone of the service we provide, we share the Committee's interest in protecting the retirement benefits of the Nation's workers and retirees and in enhancing the economic and investment environment.

I should like first to comment briefly on S. 901, with the understanding that others in our Division are more directly involved with the workings of ERISA than I and would be better able to respond to questions. In fact, I have appended to my statement (Appendix A) a speech, "Should ERISA Be Amended?" by Bernard F. Curry, our Senior Vice President in charge of Pension Trust Administration, who is expert on this subject.

We are pleased with the Committee's constructive efforts through S. 901 to remedy deficiencies in the workings of ERISA. We have only four points to suggest.

First, we have been asked whether we have any specific views about the sharing of responsibilities for the administration of ERISA. We concur with the Committee that the Department of Labor be charged with all responsibility for interpreting, administering, and enforcing ERISA, including fiduciary responsibility and prohibited transactions, with the exception of those matters that are strictly questions of Federal tax law. We feel that those matters should be left to the supervision of the Internal Revenue Service.

Second, while the Committee is focusing on elimination of the problems arising from dual administration, I would urge it to eliminate the list of prohibited transactions and replace it with a rule that judges the validity of transactions between fiduciary and party-in-interest on the basis of adequate consideration. We think that most everyday transactions will be acceptable when viewed in that light. We believe they are within the spirit expressed by Senator Javits that, although Section 406 prohibits conflict of interest situations, "the positive benefits achieved by existing arms-length legitimate practices must be maintained. The Act was passed to prohibit abuse, not to abort legitimate transactions."[1]

Third, S. 901 amends ERISA to provide that civil penalties may be assessed by the Department of Labor where a party-in-interest transaction has taken place. Because the bill so broadly defines party-in-interest, this provision would put fiduciaries in the position of continuing on uncertain ground in making investments. We think this section should be deleted. We are confident that ERISA as it stands provides sufficient protection to participants and their beneficiaries.

Finally, we share the concern of this Committee that too strict interpretations of the Prudent Man Rule are inhibiting some pension plan managers from investing in small companies. We do not believe that a proper interpretation of the statute so constricts investment by trustees. On the contrary, we are confident that ERISA provides great flexibility for pension investment managers to invest in small companies. My testimony today will demonstrate our strong belief in such investment. While we consider that the Act as it now stands provides sufficient authority for such investment, my colleagues have suggested that amendment to Section 404(a) might be in order to assuage the concern of others about investment in smaller companies. Our counsel has drafted language which we believe is worthy of consideration by the Committee and I have included it in the material I have submitted (Appendix B).

Turning now from S. 901, I am sorry to say that we have a much less favorable view of S. 285.

We believe that this bill is based on important misconceptions of the nature of the pension investment business and that, if it became law, it would diminish rather than increase the prospects for the safe and successful investment of the $240 billion in private pension-plan assets that are to provide retirement income to millions of American workers.

In our view, there are four principal misconceptions.

1.) Investments would be more diversified if smaller managers as a group had more assets under management and large managers had less.

The fact is that larger bank trust departments are more diversified than smaller ones and that Morgan Guaranty, instead of being an example of poor diversification, is ahead even of the other large trust departments.

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[1] Hon. Jacob K. Javits, "Pension Reform: Legislative Event, Administrative Progress and Future Congressional Action" (Seventh Annual Conference of Human Resource System Users, Chicago, Nov. 8, 1976).

2). Pension managers need the provisions of this bill to invest in smaller companies.

The fact is that Morgan Guaranty has been investing pension assets in small and medium companies for more than 15 years. We believe that this can be done prudently under existing laws, although it requires resources of people and money not available to smaller institutions.

3). Large pension managers have a dominant power over securities prices.

A stringent examination of the actual effect of institutional activity on market prices disproves this belief.

4). Unless certain pension managers are limited in their investments, they will achieve too much control over the economy.

The fact is that there is no such danger.

As to the misconception about diversification, we have found no reliable evidence indicating that institutionally managed pension portfolios are inadequately diversified and, hence, exposed to undue risk. On the contrary, the weight of informed thinking[3] on the subject is that diversification is more than adequate for the purpose of minimizing risk.

In addition, large trust divisions, against which S. 285 is directed, are more diversified in their equity investments than smaller ones. This should not be surprising. It takes money and people to invest prudently in a broad range of companies and there is no way smaller investment organizations can do this. Just the same, the facts are striking: Banks with managed equities of over $1 billion had nearly twice the number of stocks in their portfolios than did banks holding between $500 million and $1 billion of equities and nearly three times the issues held by banks in the $250-to-$500-million category. Furthermore, the concentration of stocks in the largest dollar holdings was 20 percent to 50 percent greater in those banks with equity holdings of under $1 billion in equities than for those whose holdings amounted to more than that figure (appendix C).

In the case of Morgan Guaranty, the data show that our holdings are more diversified than those of banks in our own category of size as well as smaller banks. Specifically, the number of stocks we hold and follow is five times as large as that in the average bank trust department and 85 percent greater than the average of the other largest ones. Over 800 equity issues are held for our pension clients, of which only nine account for more than 1 percent each of pension assets. In terms of equities only, the 10 largest holdings in our pension trusts accounted for 22.6 percent of the value of total pension equities, compared with 37 percent for other large banks and about 29 percent for the Standard & Poor's Composite Index of 500 stocks.

The reason we can diversify prudently is that we have the resources to do so and these resources are a function of size. They include a research staff of 70 analysts and the investment and administrative capability of maintaining 14 commingled pension trust funds so that even the smallest trust under our management can be diversified as broadly as the largest. As a consequence, the typical pension account has an interest in 642 equities.

Another misconception is the idea that investment managers need additional legislation before they can invest pension funds in smaller companies. The provisions of ERISA are often cited in this connection. We find these concerns somewhat puzzling. It is true that ERISA made a lot of people fiduciaries who had not so regarded themselves previously, but this obviuosly did not change the status of banks like ourselves; we have always been fiduciaries and are accustomed to the status. Nor is there anything in the legislative history of ERISA to indicate that one of its purposes is to discourage the investment of pension money in smaller companies. Instead, the law mandates diversification—certainly encouraging to broadly invested portfolios such as ours. The federal Prudent Man Rule in ERISA is, if anything, more liberal than the rule we had been operating under.

Although I know this Committee is clear on the point, perhaps some people confuse venture capital investments with all investments made in small companies. Of course, they are not at all the same thing. A venture capital investment is an investment in a company which is not only in an early state of development but has only securities which are privately held. In other words, a venture capital company has yet to go public. Venture capitalists are entrepreneurs who

[3] Laurence Fisher and James H. Lorie, "Some Studies of Variability of Returns on Investments in Common Stocks," *Journal of Business*, Vol. 43, No. 2 (April, 1970).

must be prepared to tie up their money until there is a public market for the company's securities, to participate actively in the direction and management of the company and to run the risk of what is often said to be a 70 percent to 90 percent failure rate—all in the hope of commensurate gain. We believe that this important function is not a suitable one for bank trust departments investing pension funds. In our view, it should be left to the numerous venture capital firms who specialize in this activity.

Where we come in is in participating in the market for these companies after they go public with an offering registered with the SEC. This is a vital link in the chain of events that produces capital for companies in a start-up stage because most venture capital investments are made in the anticipation of a public offering if they should reach a point of success that makes their stock attractive.

Although we have generally stayed away from venture capital investments as we define them and feel that we should continue to do so, we have a long history of investing in small and medium-size companies.

One of our Division's commingled funds, the Special Situation Investments—Equities Fund, has invested in more than 400 companies since it was created 16 years ago. The smallest of these had a market capitalization at the time of investment of less than $10 million and the largest approximately $100 million. I should perhaps add that from its inception in its present form in 1964 through the end of 1976, this fund showed a time-weighted compounded annual rate of return of 9.1 percent, a figure which can be compared with a 5.8 percent annual return for our portfolio of large companies over the same period and 5.9 percent for the S. & P. 500—all of which gives us every incentive to continue to seek out smaller companies with attractive prospects.

Nor is this fund small or otherwise insignificant in our scheme of things. Its holdings in 218 companies had a market value of $656 million at the end of last year and typically represented 6.7 percent of the value of the common stocks in a participating pension fund.

An even larger proportion—8.3 percent—was invested in another of our commingled funds that concentrates on medium-sized companies. Its yearend market value was $817 million, representing holdings in 136 equities.

Partly as a consequence of the investment in these funds, the companies in which we have concentrations are for the most part not the giants. For instance, more than 80 percent of the companies in which our Division at yearend held more than 5 percent of the outstanding shares had market capitalizations of less than $500 million and 55 percent had market capitalizations of less than $100 million. Of our 123 pension-trust holdings that exceeded 5 percent of common stock outstanding at the end of last year, fully 98 were in companies having a net worth of less than $150 million, the line of demarcation that would be set by the bill.

When our analysis leads us to conclude that a smaller company's future is sufficiently attractive to offer a return commensurate with the risk involved, that company. At the same time, we would not under any circumstances invest we are able under existing legislation to invest our pension client's money in in a small company where our analysis suggests the risk outweighs the possible return.

The fact that the proposed legislation is designed to protect us legally from the consequences of making certain investments does not change this view. After all, it does not propose to protect the pension beneficiaries against the consequences of risky investing nor would it protect us against the wrath of our clients, the plan sponsors. S. 285 recognizes that investing in the smaller companies requires taking larger proportionate positions to justify the additional costs and to make the holding meaningful to a portfolio. However, as I will discuss later, imposition of any artificial ceiling in terms of net worth or other measure introduces numerous problems, all of which could be avoided if the percentage ownership limitation were not introduced in the first place.

S. 285 is also, in our view, based on misconceptions concerning the power of large trust departments over securities prices. We have seen no hard evidence contradicting the conclusion of the SEC's 1971 Institutional Investor Study[3] that "institutional trading overall has not impaired price stability in markets." More recent studies by highly respected academic theoreticians have confirmed

[3] *Institutional Investor Study of the Securities and Exchange Commission* (Washington: U.S. Government Printing Office, 1971) Summary Volume, p. XXI.

the SEC Study's finding. One of them, Dr. Irwin Friend, professor of finance at the Wharton School, stated:

There is no theoretical or empirical basis for believing that market efficiency, and hence the quality of market prices paid by . . . investors, has been or will be impaired by institutional trading. A number of different analyses of the impact of institutional vs. individuals, trading in stock on volatility of stock prices or on more sophisticated measures of the market's allocational efficiency have shown no important effects.[4]

Other empirical analyses by Frank K. Reilly, professor at the University of Illinois, came to the conclusion that "the evidence suggests that institutions neither contribute to market volatility nor trade together. Efforts to restrain their freedom will be counter-productive.[5]

These studies are appended to this statement (appendixes D and E).

It is important to realize that when the size of the market is taken into account, we are not as big as we at first appear. For instance, the total value of the securities managed by our Division for all kinds of accounts is less than 1 percent of all United States financial assets, and the total value of the equities which we manage for all accounts is slightly less than 2 percent of the total value of all American equities. In 1975 our trading in equities accounted for less than 3 percent of total transaction volume, and in 1976 the figure was lower. Professor Schotland, whose article[6] was referred to by the Chairman in the course of introducing S. 285 cited instances in which our Division's trading accounted during a particular period for a substantial portion of the total trading in a security and then stated that "it defies belief" that such trading did not have a significant impact on price movements. Nevertheless, our analysis (Appendix F) shows quite clearly that there was virtually no relationship between our share of trading in the stocks Professor Schotland mentioned and the movement of those shares' prices. This should not be surprising in light of the conclusions drawn by academic studies or those in the 1971 Institutional Investor Study by the Securities and Exchange Commission: "Banks . . . tend to be price neutral: Their net trading imbalances tend to be in the opposite direction to the price changes as frequently as they are in the same direction.[7] Furthermore, it is very much in our own self-interest to minimize price impact, since the performance of our clients' accounts is helped if we buy at the lowest possible prices and sell at the highest possible prices.

Professor Schotland's conclusion is particularly hard to accept in the total absence of any persuasive evidence to indicate that large bank trust departments, either singly or in the aggregate, affect stock prices in a major way through their trading. We have seen no evidence that a diminution in the amount of assets under the control of large bank trust departments, a stated goal of S. 285, would have any effect on market liquidity.

The last of the misconceptions to which I would draw your attention concerns the possibility that large pension managers will eventually achieve too much control over the economy through holdings in pension trusts. Speaking for Morgan Guaranty, I can assure your Committee that investments are made for investment reasons and not for control, and that we have procedures to avoid situations which could put the Division in the position of a controlling shareholder within the meaning of the various securities laws and regulations.

While it is our duty to vote the stocks for which we have authority, that duty is shaped entirely by our responsibility to protect the interests of the beneficiaries of the plans that own the securities. In voting we are naturally concerned with the overall quality of management of portfolio companies, but we know that we do not have the time and believe that we do not have the talent to second-guess the decisions being made every day by the managements of such companies. If our ongoing analysis of a portfolio company gives us reason to believe, rightly or wrongly, that the management of the company is not doing its job well, we would consider reducing or eliminating our holding, but we would not attempt to assume a role in the active management of the business.

[4] Irwin Friend, "The Increase in Institutional Holdings Does No Harm to the Stock Market," *Financier*, Vol. 1, No. 2 (February, 1977), p. 31. (Appendix D)

[5] Frank K. Reilly, "Institutions on trial: Not guilty!" *The Journal of Portfolio Management*, Vol. 3, No. 2 (Winter 1977), p. 5 (Appendix E).

[6] Roy A. Schotland, "Bank Holding Companies and Public Policy Today," prepared for the Financial Institutions and the Nation's Economy (FINE) Study by the Subcommittee on Banking, Currency and Housing, U.S. House of Representatives (1976).

[7] *Institutional Investor Study*, op. cit., p. 84.

While we cannot speak for every institutional investor, we have not seen emprical evidence which would indicate that large bank trust departments exericse the power, or even possess the power, to influence significantly the managerial decisions being made by the companies in which such trust departments invest.

Now I should like to talk about the ways in which S. 285, if adopted, would be counterproductive. In general, I feel that the bill's provisions are an attempt to substitute arbitrary measures for the interplay of independent financial analyses and judgments by numerous market participants acting on their own behalf or on the behalf of many different clients. Such interference with the capital allocation process can only make markets less efficient and must work to the detriment of companies seeking to raise capital and investors seeking to invest rationally.

Has the committee considered how many companies' stocks would be instantaneously subjected by the bill to inefficiencies in the market's pricing? One cannot tell from existing data the number of companies in which a pension manager owns over 5 percent of the outstanding shares. However, the Comptroller of the Currency's data indicates that there are 180 companies which have at least one large institutional holder of 5 percent or more of the outstanding shares. In effect, the respective pension managers holding 5 percent of these stocks could make only one portfolio action decision—that is, to sell—no matter how attractive the outlook for the stock appeared to be. Clearly this would produce a negative drag on the market for those shares, making the raising of equity capital more difficult and costly for those companies. The resulting inefficiency is far from trivial when one considers that the group of literally "one decision" stocks, which S. 285 would create would be at least three times as large as the so-called "nifty 50," which at one time was of major concern. I would note that the market's ability to work its way out of the "two-tier" pattern of the early 1970s without legislation further illustrates the efficiency of the free market in achieving self correction.

Ironically, the arbitrary 5 percent limitation would not necessarily result in better diversification. Should the law encourage new money flows to go to smaller investment institutions, there is no guarantee this money will be invested in the shares of corporations the legislation seeks to help. In fact, as discussed previously, the available evidence suggests that transferring assets from larger to smaller institutions will actually diminish diversification. To underscore the point that the intentions of the bill's sponsors would not necessarily be served by the bill's implementation, I would note that if under S. 285 we were to reduce our clients' holdings to 5 percent in the 23 companies whose individual net worth exceeds $150 million and in which our pension holdings now exceed 5 percent we would realize proceeds of perhaps $300 million. This amount could theoretically be invested in the stock of only one large company, A.T.&.T., without raising our total pension holding of this stock above 1 percent of the outstanding shares. Clearly, such action, possible under the proposed law, would hardly accomplish the stated purposes of the bill.

I am afraid that establishing a mechanistic rule designed to fit all circumstances would only create an entirely new set of problems. In recognition that a 5 percent limitation is not realistic in the case of smaller companies, S. 285 would exempt companies with a net worth of $150 million or less. Yet there is little intrinsic reason to treat differently the 180 publicly held companies whose net worth would fall in a range between $150 million and $200 million from the 240 companies whose net worth is between $100 and $150 million. Yet permitting unlimited ownership in the companies with a net worth below $150 million and limiting ownership to 5 percent for companies with a net worth exceeding $150 million alters the market forces which influence each group's share prices. There seems little justification for impeding the ability of companies in the $150–200 million net worth group to raise capital relative to those in the $100–150 million group.

Now let's carry this analysis a step further. Presumably, well-run companies with net worth below $150 million will be profitable and retain some earnings, causing net worth to expand year by year. Consequently, some of these companies can be expected to cross the $150 million mark at some time. It would appear quite likely that there would be a rush by institutions to establish "grandfather" positions as an attractive company's net worth approaches $150 million, which represents an artificial interference in the market's ability to allocate capital on solely investment grounds. On the other hand, as stated before, once a company surpassed $150 million in net worth, it would then have a "one-decision" element to it.

An extraordinary feature of the bill is that its avowed intention is to slow or reverse the growth of those institutional investment managers who have been most successful in attracting business. Morgan Guaranty, since it is one of the largest and most successful investment managers, is intended as a target of S. 285. It is indicative of the competitive vigor of the investment field that our equity holdings account for somewhat less than 2 percent of the total value of American equity securities. And, as I also noted earlier, the assets we hold represent less than 1 percent of all American financial assets. I cannot stress too strongly the fact that our pension business is in no sense tied to us in the intensely competitive market for investment management services. Each one of our pension plans permits the sponsoring organization to hire and fire trustees at will. These changes are frequent and involve large sums of money. An investment organization that fails to perform will soon find itself facing a very substantial shrinkage in the amount of assets under management. To suggest punishing precisely those investment managers who have been successful in attracting and managing pension plans would be a disservice not only to those in the business of investment management, but especially to those beneficiaries whose retirement incomes are to be funded from the plans we manage. We believe that S. 285 might well inhibit our ability to produce the best investment results we are capable of, and we can see no public good to be served from so hobbling our efforts and those of other managers of private pension funds.

Thank you for this opportunity to present our views. I would be glad to respond now to questions you might have, particularly those concerning S. 285.

APPENDIX A
Statement of Harrison V. Smith

Should ERISA be amended?

Remarks by Bernard F. Curry, senior vice president of Morgan Guaranty Trust Company, before the National Trust Conference of the American Bankers Association, February 9, 1977.

ERISA may have done more for Bible scholarship than any event since the flood. At least it has driven me to the Good Book for solace, such as this comment in St. Luke's Gospel, which I felt I must share with you:

> A lawyer then spoke up. "Master," he said, "when you speak like this you insult us too." "Alas for you lawyers also," he replied, "because you load on men burdens that are unendurable, burdens that you yourselves do not move a finger to lift."

In the spring of 1975 oversight hearings were begun by Congressmen Dent and Erlenborn to discover how ERISA was working, particularly in the area of fiduciary responsibility. A great deal of complaint was raised by members of the public, representatives of labor unions and other interested parties, including your Employees Trusts Committee. One of the principal points for complaint was the potential liability arising from the very broad definition of "parties in interest," the broad definition of "fiduciary," and the list of prohibited transactions. In addition, much testimony was adduced that ERISA was hampering day-to-day operation of employees trusts. One labor representative spoke most clearly when he said, "We're all in violation and we want out, now!" The result of these hearings was *H.R. 7597*, the legislative proposal introduced by Congressmen Dent and Erlenborn, which was approved by the full Committee on Labor in 1976 but not acted upon by the House of Representatives.

Members of the House and Senate have indicated in recent months that the time has come to consider amending ERISA. For example, Senator Javits in a speech last November said:

> This coming year may be the first year when we will be ready to consider amendments to ERISA which will deal with these questions of the prohibited transaction section and of the reporting and other paperwork requirements. For it now seems clear that the two department administration of ERISA by the Department of Labor and the Internal Revenue Service needs to be reviewed.

At the request of the Administrator, Pension and Welfare Benefit Programs, the Advisory Council to the Labor Department has recently completed an extensive review of suggestions for amendment to ERISA. These suggestions were compiled by the Labor Department from many sources, and were not intended as recommendations of the Department. The Advisory Council has within this past month reported to the Administrator its recommendations as to legislation.

Past and present staff members of the Department of Labor, speaking as individuals, have made a number of suggestions as to how ERISA might be improved.

Chief concerns

What should be our principal concerns after two years' experience in the application of ERISA and in the law itself?

So much has been written about the Prudent Man Rule that it is imperative at the outset to put the rule into perspective. I am appalled by the number of strict interpretations made of this rule, the recognized standard of conduct for trustees since *Harvard College vs. Amory*, which Congress intended to liberalize. It is worthy of note that these crepe hangers are not on the staff of either of the agencies. The rule as it now stands is basically that suggested by the American Bankers Association to the Congress in 1966. The ABA Committee which proposed this version of the Prudent Man Rule certainly felt that it was liberalizing the applicable rule rather than constricting the permissible limits for investment by trustees.

Flexibility for investment

George P. Shultz, former Secretary of Labor, expressed the intention of the proposed rule in these words:

> Our formula has a built-in flexibility to allow for fair judgments to be made whether the fiduciary is an individual administering a small plan with an uncomplicated portfolio or an institution administering a large plan with millions of dollars invested in many types of assets. Under *H.R. 16462*, a fiduciary will be judged by a standard of prudence in light of all the circumstances prevailing at the time he acts. Thus in any given transaction, a trust company, for example, would be evaluated in terms of other trust companies under similar circumstances, including the prevailing economic conditions, nature, size, and goals of the plan, the nature of the

transaction itself, as well as the standards expected of such specialized financial institutions. This does not mean that the standard will necessarily be a higher or lower standard than would be imposed under the traditional formulation. It will be a fairer standard, which recognizes the vast diversity and other characteristics of private pension and welfare plans.

Many of you were hemmed in by statutes for investment as trustees which included legal lists. We in New York worked for years to overturn an anachronistic statute requiring adherence to legalistic provisions. We now have a statute in New York which permits more flexibility in investments. The Prudent Man Rule enunciated by ERISA provides us with an even greater degree of flexibility. And yet we have voices crying out for ironclad rules as to what is and what is not prudent. It should be obvious that ironclad guarantees are possible only if we have a set of rules requiring strict adherence. We who have grown up in the trust business have been conscious of our responsibility to deal with our accounts without a scintilla of self-dealing but with undivided loyalty and consciousness of the need to manage the account for the sole benefit of its beneficiaries.

Submitted views

In a submission made to the two agencies by the American Bankers Association in 1975, we said:

> *Section 404(a)(1)(B)* requires that all fiduciaries discharge their duties, responsibilities, and obligations to a plan in a prudent manner. Bankers have adhered to similar standards for years, and it has been their experience that it is impossible to define what is prudent in a given case by means of specific rules and regulations. Whether an act or failure to act is prudent must be determined in light of all of the facts and circumstances existing at the time. Therefore, the ABA strongly believes that it would be inappropriate to issue regulations interpreting "prudence."

We oppose any effort to tinker with the Prudent Man Rule, or to require the agencies to prescribe acceptable modes of conduct.

The prohibited transactions sections of ERISA offer a substantially different challenge. Our everyday business is affected by the interplay of three provisions of the law: first, a litany of prohibited transactions; second, a broad definition of "party in interest"; and third, shared responsibility by the Department of Labor and the Internal Revenue Service over fiduciary responsibility.

It is hard to decide which provision is the real culprit. It is more likely that it is the interrelationship and the interplay of these three provisions which result in confusion, delay, uncertainty, and potential liability.

Effect of prohibiting transactions

Let us consider the prohibited transactions which are spelled out in *Section 406(a)* of the Statute. The Senate, with reluctant House acquiescence, concentrated on prohibiting a number of itemized transactions between the fiduciary and a party in interest, such as sales or exchanges of property, lending of money, furnishing of goods or services, and the transfer to or use by a party in interest of any assets of the plan. These prohibitions were adopted rather than a code of conduct.

The prohibited transactions, however, must be interpreted in the light of a limitless definition of party in interest [*Section 3(14)* of the Statute]. Now, who are parties in interest? Not only fiduciaries, administrators, officers, trustees, custodians, counsel, or employees of the plan and employees of the company, but also any relative of such person, which includes a spouse, ancestor, lineal descendant, or spouse of a lineal descendant. (Wouldn't Gilbert and Sullivan have had fun with that set of words?) The list of pariahs includes also a host of others, including servicers as well as substantial employers and owners. On the tax side, a definition of similar scope describes these individuals as "disqualified persons."

We have spent a great deal of time considering whether the "party in interest" definition can be reduced to minimize its deleterious effects without eviscerating the purpose of the prohibited transaction rule.

We found it quite impossible to achieve a satisfactory reduction in the persons covered. There was an element of agreement on elimination as parties in interest of servicers and employees of the company other than employees of the plan.

So it was with our review of prohibited transactions. Each provision was inserted in ERISA to protect participants against possible conflicts of interest.

Two cooks at work

As if the foregoing combination didn't cause enough difficulty, we have another complicating factor in dual jurisdiction of the two agencies. Each of the agencies has its own traditional sphere of operation and its own directive from the Congress in the enforcement of these responsibilities accorded it under ERISA. Internal Revenue Service has had responsibility for collection of taxes. Department of Labor has been dedicated to protection of working people. Dual jurisdiction mandated by the statute was an abomination from the beginning and was recognized by most people involved in the legislation as a necessary compromise, but not a workable one.

At this point it is important to recognize that I'm not harping on the labor provisions of the law. Each provision we have considered has a parallel provision in the responsibilities given to the IRS. This dual responsibility has compounded the problem. When you read "Secretary" anywhere in the Statute, you should recognize that the IRS must also participate in all the proceedings and concur in final decisions that are made.

Exemptions as a remedy

During the progress of the legislation we discussed with individual congressmen and staff the problems we anticipated in the application of these rules. The automatic answer was that an exemption procedure would be included which would alleviate the harshness of the rules. When we had the opportunity of reviewing the exemption provisions we stated quite plainly that they wouldn't work. Unfortunately, we have been proven right.

Senator Javits in his November speech referred to 480 exemption applications on file, of which approximately 60 have been resolved. There has been some good progress since then, but the basic problem remains.

A review of the procedure for exemptions from prohibited transactions will illustrate the problems we foresaw. The Statute *[Section 408(a)]* provides:

> The Secretary may not grant an exemption under this subsection unless he finds that such exemption is
> (1) administratively feasible,
> (2) in the interests of the plan and of its participants and beneficiaries, and
> (3) protective of the rights of participants and beneficiaries of such plan.
> Before granting an exemption under this subsection from *Section 406(a)* of *407(a)*, the Secretary shall publish notice in the *Federal Register* of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons opportunity to present views. The Secretary may not grant an exemption under this subsection from *Section 406(b)* unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2), and (3) of this subsection.

The procedure was established to eliminate hardship as long as the exemption was consonant with the protection of participants. But it has created a monumental log jam which prevents the orderly operation of the Law.

The two-year record

After two years what has been the record? Fewer than two handfuls of exemptions have been granted by the agencies. Most of the applications granted exempt individual transactions and have no universal application. In view of the time expended on these applications clearly something must be done. This record persists in spite of dedicated, intelligent, hardworking people in each group laboring with good will to interpret the Law.

Two applications for exemption already filed by the ABA and another scheduled for early filing will provide some insight into the burdens of coping with ERISA.

(1) The first application filed in December 1976 requested issuance of a class exemption from prohibited transactions with respect to certain acquisitions of certificates of deposit and other obligations of banking organizations. Its purpose is to eliminate possible violations of the prohibited transactions rules of ERISA where more than one bank is trustee or investment manager of a single employee benefit plan, responsible for the investment and administration of its own portion. The possible violation arises when one bank invests short-term money in the obligations of the other.

(2) In January of this year we filed another application to request a class exemption from prohibited transactions of purchase of securities by employee benefit plans when the proceeds of sale are used by the issuer of securities–directly or indirectly to retire or reduce indebtedness to banks which are parties in interest or disqualified persons with respect to the employee benefit plans.

(3) Operation by corporate trustees of collective investment funds presents additional possible prohibited transactions. At issue here is the question of whether you "look through" the collective trust to the participating plans for determination of parties in interest and prohibited transactions. We believe that an understanding of the nature and operation of the collective trust fund will permit an exemption which will eliminate these problems.

These three applications exemplify obvious problems we have in coping with ERISA. They by no means exhaust the subject. Each time a group of interested people meet we discover new sets of problems.

Many of the problems we recognized in the drafting stage – but not all. Those we did see impelled us to support the prohibited transactions provision in the House version of the legislation; it, stated quite simply, would permit transactions with a known party in interest in return for no less than adequate consideration.

Beyond these recommendations for improvement in ERISA, there are strong feelings in the pension community that the concept of dual administration of the agencies must be reversed. It was a self-destructive concept *ab initio.* Even with good will on the part of each participating agency, joint responsibility creates a need for continuing dialogue which in practice has resulted in unhealthy delays. The basic problem is more substantial: Each agency interprets the Statute from its own tradition and with consciousness of its own role in the statutory scheme.

Redefine jurisdiction

Therefore, we recommend that the Department of Labor be charged with all responsibility for interpreting, administering and enforcing ERISA, including fiduciary responsibility and prohibited transactions, with the exception of matters which are strictly questions of Federal tax law. Excise tax provisions relating to prohibited transactions should be removed. Prohibited transactions should be enforced by the Department of Labor through the courts.

We recommend further that the Congress repeal *Sections 406(2)* and *2003* of ERISA and permit transactions with a known party in interest for adequate consideration. Such transactions are ordinary business transactions, the validity of which is provable by extraneous evidence and they should be permitted within the rules provided. This rule would permit arm's length transactions within the intent of the Statute and would not result in abuse. Knowledge of transactions in employee benefit accounts resulting from the reporting and disclosure requirements of the Statute will militate against infractions.

We believe they are within the spirit of the statement in Senator Javits' November 8th speech recognizing that, although *Section 406* prohibits conflict of interest situations, "The positive benefits achieved by existing arm's length legitimate practices must be maintained. The Act was passed to prohibit abuse, not to abort legitimate transactions."

As part of this recommendation, we urge that Congress increase staff and equipment of the Department of Labor for monitoring the operation of plans.

I mentioned earlier that the Advisory Council to the Secretary of Labor had made suggestions for amendments to ERISA. Dual administration and adequate consideration were covered in recommendations similar to those just expressed.

Other necessary changes

There are several other changes in the law we believe necessary. While not as basic to the orderly application of the law, they are of substantial importance to us as corporate trustees and as employees of such organizations.

"Fiduciary" is defined in such broad terms under the Statute that the definition could even be read to include each individual employee of a corporate trustee. We believe this does not recognize the manner in which corporations normally operate.

Every corporation must act through individuals. The selection of the corporate trustee is made after careful analysis and review of its policies, reputation, experience, performance, and indeed consideration of its financial stability. No review is made of the financial condition of the individuals who will operate the account, nor is one possible.

In our comments to the agencies dated March 13, 1975, we referred to this question in these words:

> In these cases, the sponsor of the plan selects an entity to be its trustee or other fiduciary, not the individuals who are associated with and who act on behalf of the entity. Without such individuals, entities which serve as fiduciaries cannot act; however, such individuals do not act in their own right or on their own behalf, but solely on behalf of and in the name of the entities with which they are associated. The inseparability of directors, officers, and employees from a corporate trustee has been universally recognized, for example:
>
> Although a corporate trustee cannot properly delegate the administration of the trust, it can properly administer the trust through its proper officers. *Restatement, Trusts, 2d, Section 171e.*
>
> The artificial legal entity which is the corporation cannot act personally. It can proceed only through its officers and employees or other intermediaries. The use of officers and employees is not delegation but rather action of the trustee itself. *Trust and Trustees, Bogert, 2d Edition 1960, Chapter 27, Section 555.*

Furthermore, the act seems to recognize this inseparability in *Section 405(d)(1)*, which protects the trustee from liability for following the instructions of an investment manager. If the directors, officers, and employees acting on behalf of a corporate trustee were fiduciaries, they could arguably be liable for carrying out instructions of an investment manager even though their employer was relieved from liability for their actions. Such a result would be intolerable, and could not have been intended.

We suggest that this problem can be resolved in a very simple addition to the statutory definition in *Section 3(21)* such as was proposed in *H.R. 5797.*

> (c) If a corporation or an employee organization is a fiduciary with respect to a plan, under subparagraph (A), a director, officer, or employee of such corporation or employee organization when acting in such capacity, shall not be a fiduciary with respect to such plan.

Section 405(a) of ERISA creates liability for breach of fiduciary responsibility by a co-fiduciary. Liability requires some complicity in the breach, specifically a knowing act or omission on his part enabling the other fiduciary to commit a breach in the course of his administration of his specific responsibilities or having had knowledge of a breach, not making reasonable efforts under the circumstances to remedy the breach.

Section 405(b) of the Statute introduces somewhat ambiguous language into the liability created for actions of "co-trustees" – in *405(b)(1)(A)* a co-trustee is required "to use reasonable care to prevent a co-trustee from committing a breach."

You and I consider ourselves co-trustees only in those instances in which the instrument creating the trust appoints us to act in concert over the same assets. The Conference Report seems to recognize this when it says:

> Allocation of duties of co-trustees. – Under the conference substitute, if the plan assets are held by co-trustees, then each trustee has the duty to manage and control those assets. For example, shares of stock held in trust by several trustees generally should be registered in the name of all the trustees, or in the name of the trust. In addition, each trustee is to use reasonable care to prevent his co-trustees from committing a breach of fiduciary duty.

This status of being a co-trustee is quite at variance with the situation where each of several trustees is given responsibilities, obligations, and duties over a different portfolio.

The Statute and the Conference Report recognize in several places that pension assets of large plans have multiple trusteeships and multiple managers. It is to be regretted that *Section 405* of the Statute does not more accurately assign liability in recognition of the existing practice.

We have been troubled by this language since passage of ERISA and commented on it in our March 13, 1975 submission to the agencies. We are having drafted proposed amendments to *Section 405* for Congress' consideration. These amendments will have the effect of limiting co-fiduciary liability to those situations in which fiduciaries act in concert over the same assets.

Many of our clients are concerned with the cost, the burden, and the utility of the extensive reporting and disclosure requirements of ERISA. Several of them have made their concerns known to the Federal Paperwork Commission, which has filed a rather exhaustive report of its findings.

We believe that reporting to the Department of Labor and Internal Revenue Service should be limited to that information which will enable them to uncover unusual or illegal investments or other harmful actions by fiduciaries. Dutiful reporting of routine transactions obfuscates the important transaction which should be the subject of agency overview.

I am confident the Congress will resolve the jurisdictional problems and provide a more efficient supervisory method if it is made to understand the serious difficulties of the pension community in coping with ERISA. It is up to us to encourage our clients to provide Congress with the hard facts.

APPENDIX B
Statement of Harrison V. Smith

Suggested amendment to be added as Paragraph (3) to Section 404(a) of ERISA:

(3) Neither the acquisition nor the holding of any investment in securities shall be deemed to violate the requirements of paragraph (1) (B) merely because the issuer of such securities is relatively small or because its securities are not widely held or regularly traded.

APPENDIX C
Statement of Harrison V. Smith

Diversification of equity holdings among banks by size of equity assets reported

	Equity assets (millions)	Number of banks	Average number of stocks	Percent of equity portfolio value: Largest holding	5 largest holdings	10 largest holdings	Largest industry	2nd largest industry
Sept. 30, 1976	Under $100	24	51	16.1%	40.9%	57.3%	20.6%	12.2%
	$100 to 250	39	83	21.5	40.4	52.1	25.3	9.4
	$250 to 500	26	150	21.2	39.7	49.7	25.1	11.1
	$500 to 1000	15	200	11.1	29.6	41.1	16.4	9.7
	Over $1000	24	447	11.2	24.8	34.5	16.4	9.3
		125						
Average		-	173	12.5	27.2	37.3	17.6	9.5
Morgan Guaranty		-	832	9.1	19.9	27.7	10.4	7.0
Dec. 31, 1975	Under $100	35	54	15.8%	41.2%	56.8%	19.4%	11.4%
	$100 to 250	39	95	20.8	39.5	51.2	24.8	10.0
	$250 to 500	24	150	19.6	37.8	48.6	22.6	10.6
	$500 to 1000	12	244	9.3	25.5	37.1	14.4	8.6
	Over $1000	21	462	10.7	24.8	35.0	15.9	9.7
		131						
Average		-	167	12.0	27.2	37.7	16.9	9.8
Morgan Guaranty		-	744	9.0	20.8	30.0	10.5	8.2

Source: Data filed with the Comptroller of the Currency, as reported by Computer Directions Advisors, Inc. It should be noted that these data do not include those for the many state-chartered banks that do not make voluntarily reports to the Comptroller.

APPENDIX D
Statement of Harrison V. Smith
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FINANCIER: *Text*

The Increase in Institutional Holdings Does No Harm to the Stock Market

by Irwin Friend

Contrary to widespread assumptions, the increase in the relative importance of institutional stock trading has not hurt the quality of the stock market, nor created any disadvantage to small investors, Dr. Friend told the Salomon Brothers Center conference on the national securities markets at New York University. He found no need, therefore, for new laws to discipline further the activity of large institutions in the marketplace. An excerpt from his talk:

There is no theoretical or empirical basis for believing that market efficiency, and hence the quality of market prices paid or received by either institutional or individual investors, has been or will be impaired by institutional trading. A number of different analyses of the impact of institutional vs. individuals' trading in stock on volatility of stock prices or on more sophisticated measures of the market's allocational efficiency have shown no important effects. Thus, if the market's allocational efficiency in the U.S.A. is measured by the ability of the stock price structure at any time to predict the subsequent flow of per share earnings, holding constant risk and dividend payout policy, I have been able to find no significant change in the market's efficiency in the entire post-World War II period in spite of the greatly increased stock activity by institutional investors over this period.

Turning to a more direct test, if we relate the relative importance of institutional net stock purchases of different stocks to the ability of the prices of these stocks to predict the subsequent flow of share earnings, we again find no evidence that institutions either add to or detract from the market's allocational efficiency. To assume that this situation is ~~likely to~~ change in the future is to imply that institutions are less likely than small individual investors to make informed decisions when they buy or sell stock. Such an assumption would mean that institutions have less insight into intrinsic stock value than the rest of the market—which seems implausible. If this were true, one consequence which would be expected is that institutions would have a poorer investment performance than individuals, but in fact on the average they appear about equal.

Slight Price Effect

While there is no reason for believing that the basic allocational efficiency of the market is impaired by expanded institutional trading, there is some weak evidence that sales of large blocks may have a small adverse effect on market price in the sense that prices recorded on the ticker may temporarily fall. Purchases of large stocks apparently do not have a corresponding temporarily stimulating effect. The adverse price effect of sales of large blocks in 1968 and 1969, according to this analysis, seems to have averaged somewhat over .7 of one percent, but since only blocks associated with down ticks were included and total sales of the stock were not held constant, even this relatively small figure probably overstates the block effect. Moreover, the small temporary discount necessary to bring in willing buyers quickly seems to have been largely dissipated by the end of the day of the block trade.

Even this apparent temporary and short-lived effect on price, however, may be the reflection of an incomplete analysis. In a recent more complete but as yet unpublished analysis it is found that the short-run volatility of the prices of different stocks is not significantly related to the ratio of institutional to total holdings of these stocks, once longer-run price movements (and other relevant variables) are held constant; and there is no indication of any adverse effect of institutions on the market even in the short-run. Thus, the frequently cited examples of large institutional purchases and sales being associated with substantial short-run movements in stock price may simply reflect the fact that the institution involved is acting on the basis of significant new information which in an efficient market would be expected to appreciably change stock price.

If there is any short-term adverse impact of institutional trading on price, though the evidence is not at all clear, the effect is quite small and may be regarded as an increase in transaction costs to the institutional sellers of these blocks necessary to mitigate a short-term supply-demand imbalance. However, while the institution may have to pay a small cost for speedy execution of a large block, there is no significant harm to other investors on a net basis. Investors buying the stock from institutional sellers on a day of a block trade – a period when individuals and other non-institutional investors are presumably net purchasers of stock – benefit from the temporarily depressed prices.

If attention is directed to the normal bid-ask spread of stocks in which institutional investors are active rather than to the short-run effect of block trades, there is some indication that institutions by their presence in the market may reduce rather than increase transaction costs for the average investor. Thus, an earlier analysis suggests that the larger the number of institutional investors holding a position in an issue (for given values of trading volumes and other relevant variables) the smaller the bid-ask spread. A more recent and more comprehensive analysis not yet published similarly indicates that holding the relevant variables constant, the higher the ratio of institutional holdings to total holdings of a stock, the smaller the bid-ask spread.

Bond Market Questions

While there is no evidence indicating a worsening of stock market efficiency associated with the past institutionalization of trading, attempts have been made to point out the dangers of this trend by reference to the supposed deficiencies of the bond markets in which institutions, large transactions and dealers predominate. It has been argued that the bond markets – especially those for U.S. Government and corporate issues – are largely institutional and dealer markets; that individuals have been relatively unimportant in these markets since the 1920's as a result perhaps because of factors associated with the growing institutional participation; and that, as a result, these markets are inferior to the auction markets which are associated with a large number of individual trades.

It is not clear in what sense the market for U.S. Governments can be considered inferior to the markets which are more heavily auction in character. The Government bond market handles the largest volume of any of the securities markets at probably the lowest transaction costs, reflecting the ability of dealers with substantial capital to manage successfully the problems posed by large blocks. The market for corporate bonds is characterized by significantly higher transaction costs with more sizable bid-ask spreads, but even here there is no evidence that comparable costs are on the average higher than those for corporate stock.

Moreover, there does not appear to be any reason to ascribe the diminished role of individuals in these markets to factors associated with the growing institutional participation. Individuals probably found U.S. Government and corporate bonds less attractive but, at least in part, because bond yields remained extremely low for several decades relative to other yields, and increases in personal income tax rates lowered further the effective yield on bonds as compared with stock. Most groups of institutions on the other hand were largely legislated out of the stock market in the U.S.A. until about 1950 and were not subject to the same income tax deterrent. With the rapid rise of bond yields in recent years individuals have become a more important part of the bond market, especially for corporate issues. Thus, for corporate and foreign bonds, the share of households in total holdings rose from well under 10% in 1965 to 20% in the early 1970's.

Capital-Raising Not Impaired

Any inference that the comparative absence of individuals from the corporate bond market has impaired its usefulness for raising new capital for corporations is contradicted by the historical rise in the share of new corporate financing accounted for by bonds at the expense of equity securities. The rise since the 1920's has been substantial. Again, however, non-institutional factors – such as the increase in corporate income taxes which makes debt financing relatively less expensive – probably accounted for this development.

Another argument which has been made is that institutionalization of trading might harm new equity investment in the U.S.A., apparently in part because of its allegedly adverse effect on the market for outstanding stock issues. I have already indicated that there is no reason to believe that the market for outstanding issues would be adversely affected, and indeed the growth in institutional stock ownership in the 1950's and 1960's may have contributed to the marked rise in stock prices during this period and to the apparent decline in the relative cost of equity financing. Institutions may have had such an effect in two different ways; i.e., by adding to the overall demand for stock, and by reducing transactions costs, at least compared with small individual investors, on the acquisition of a diversified portfolio of stocks.

Turning to the relevant evidence for the new issue market, the decline in the relative importance of new equity financing in the U.S.A. immediately after the 1920's obviously had nothing to do with the institutionalization of equity markets, which really did not start until after 1950. Only starting in 1970, at a time when the institutionalization of markets was at a peak, was there a marked resurgence of new equity financing, with only a temporary dip during the depressed stock market in 1974. This resurgence has apparently not been effectively deterred by institutionalization.

While the total supply of new equity financing has probably not been depressed by the growing institutionalization of the market, the supply of unseasoned or risky new issues may be adversely affected. It is true that institutions are more risk-averse than individuals, so that, other things equal, a shift in stock ownership to institutions might be expected to lead to an increase in the cost of capital to risky seasoned firms and to unseasoned new enterprises. However, there is no reason to believe that this effect has been large and perhaps the main result may have been to reduce or eliminate an apparent historical inefficiency in the U.S. new issues market, where the rates of return realized on unseasoned new issues have generally been lower than for seasoned stocks.

Irrationality Not Expected

Finally, some students of finance have suggested that the rapid growth of institutional equity investment will, in the absence of a substantial rise in new stock flotations, lead to dangerously high stock prices, especially for large seasoned issues, and may require the imposition of curbs on such investment. Neither our analysis nor any other I am familiar with lends much support to this concern, though there is reason to believe that the pension funds and mutual funds may have contributed to the postwar rise in stock prices of the 1950's and 1960's. So far, it appears that the growth in institutional investment may have helped to reduce the former substantial disparities between the returns on equities and those on other investments rather than to inflate stock prices in relation to prospective returns. There is no reason to expect that in the future, even if the date of new stock flotations does not increase markedly, institutional investors as a whole would be any more irrational than other investors in bidding up the prices of stock beyond their intrinsic values.

A growing rate of institutional equity investment might, of course, be detrimental to the economy, totally apart from the dangers of an unduly high level of stock prices, if – because of faddism, excessive speculativeness, or other reasons – the structure of stock prices were distorted in such a way as to diminish market efficiency and the stability of stock prices were adversely affected. Again, however, the evidence referred to in this paper suggests that institutions were about as efficient in their equity investments as the market as a whole and did not adversely affect market stability. As a result, market efficiency considerations do not seem to provide any justification for new securities regulation limiting the role of institutional equity investors. □□□

APPENDIX E
Statement of Harrison V. Smith
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Institutions on trial: Not guilty!

The evidence suggests that institutions neither contribute to market volatility nor trade together. Efforts to restrain their freedom will be counter-productive.

Frank K. Reilly

The substantial increase in equity trading by large institutional investors and an increase in the proportion of total trading done by the institutions [see footnotes 1, 2, 5, 6, 8, 9, 18, 26, 30] have disturbed many observers who feel that trading by institutions leads to increases in the variability of stock prices. They believe that this happens either because institutions trade large blocks of stock or because institutions tend to trade together [1, 4, 12, 14, 16, 17, 23]. Unfortunately, there is very little direct empirical evidence on this important question of the relationship between trading by institutions and stock price volatility.

Moreover, the prevailing *ad hoc* belief on Wall Street is that there is a *positive* relationship between institutional trading and aggregate stock price volatility. This belief prevails even though several studies on the specific effect of block trades on the price of the individual stocks have generally indicated there is *not* a significant liquidity cost involved in block trades [7, 10, 19, 24]. Further, another study indicated that institutions do *not* trade together [11].

Apparently, there is a very real divergence between the prevailing belief on Wall Street and indirect empirical evidence. Because of such a divergence, this paper is concerned with a direct analysis of the relationship between institutional transactions and stock price volatility during the past twelve years. Although further analysis is hindered by the lack of data, this empirical examination of the relationship for the recent period provides some insights into the influence of institutional trading on stock price volatility.

TIERING

Another related concern has been that the institutions have caused a tiered market for common stock because of their unique portfolio requirements — i.e., they must invest in large firms with liquid secondary markets [1, 8, 12, 15, 25, 28, 32]. A paper by Reilly on the effect of a tiered secondary market on corporate financing considers these institutional needs in detail [21].

The important point is that the tiered equity market was caused by the increased impact of institutions and their unique needs. Further, since the impact of institutions on the equity market will remain and probably grow, in fact, no reason exists for their unique needs to change. Therefore, one would expect the tiered market to be a continuing phenomenon. Given a tiered market, the financing implications for the firms in the top tier are generally favorable and improving as discussed in West and Tinic [31].

In contrast, the financial outlook for the majority of firms in the bottom tier is quite discouraging. Specifically, the many companies in the bottom trading tier will probably have very poor secondary markets for their stocks and consequently will find it difficult to attract new equity capital. The several alternatives outlined by Reilly [21] available to firms in the bottom tier are not very appealing at best, and actually are discouraging for the firms involved and for the aggregate economy.

Because of the relatively adverse implications of the tiered market, a number of suggestions have been proposed to solve the problems of the tiered markets. Notably, some of the "solutions" to the problem are also solutions suggested by those who contend that institutional trading causes an increase in stock price volatility. Therefore, it seems appropriate to consider the volatility concern and the tiered market solutions together.

The initial section of this article contains a de-

* The author acknowledges the assistance of John Frothingham and the use of the computer facilities at the University of Illinois.

scription of the data and the tests employed in the analysis of the relationship between institutional trading and stock price volatility. The subsequent section sets forth the results and discusses them in terms of the prevailing belief that there is a positive relationship between institutional trading activity and aggregate stock price volatility.

The results do *not* support the belief that there is a strong positive relationship between institutional trading and stock price volatility. Given these results and the results of other studies, some of the rather drastic solutions proposed to alleviate the tiered market problem and reduce stock price volatility deserve critical evaluation. These solutions include breaking up the institutions, severely limiting their holdings in individual stocks, and restricting the trading of the stocks in institutional portfolios.

The conclusion is that many of the solutions to the two problems are either unnecessary or would not solve the problem. In some instances, the solutions are possibly counterproductive. The paper ends with a summary and conclusion that considers the implications of these results for those who advocate legislation for the institutions.

INSTITUTIONAL TRADING DATA

A major reason for the lack of analysis of the relationship between institutional trading and stock price volatility is the difficulty of finding a series that indicates institutional trading activity during reasonable time intervals for a long period. The series employed in the current study is "Stock Transactions of Major Financial Institutions" (referred to as Inst. P&S). The financial institutions included are: (1) noninsured private pension funds, (2) open-end investment companies, (3) life insurance companies, and (4) fire and casualty companies. The data are reported quarterly and are derived from the SEC "Statistical Bulletin" for the period from the beginning of 1964 through the second quarter of 1975 (46 quarters) [27]. There are also annual figures for the thirteen years, 1962-74.

In addition to examining the absolute level of purchases and sales, a relative measure of institutional activity was considered. Specifically, a ratio was derived of the purchases and sales by institutions compared to the total dollar value of stock volume on United States Securities Exchange during the quarter. This total value of trading figure encompasses all round-lot sales and odd-lot sales and is likewise contained in the Statistical Bulletin. Some observers may prefer an adjustment to the total volume figure because the institutional transaction figure includes purchases *and* sales. Notably, if both series are consistent over time, the only change would be a matter of scale.

STOCK PRICE VOLATILITY

The stock price series used is the Standard and Poor's Composite Index of 500 stocks [29]. This series is appropriate because it includes a large cross section of stocks listed on the New York Stock Exchange. This segment of the total market seemed appropriate, since the bulk of institutional trading takes place on the NYSE and, therefore, if there is an effect it should show up in these figures. Three measures of stock price volatility were considered:

1. Percent change in stock prices during the period. Specifically, the percent change from the close on the last day of period t-1 to the close on the last day of period t.

   $$Cl_{(t)} - Cl_{(t-1)}/Cl_{(t-1)}$$

   This variable is referred to as PC S&P.
2. The absolute value of the percent change in stock prices. This is the same as the first measure except that it ignores the sign of the change and only considers the *size* of the change. This variable is referred to as Abs. PC.
3. The difference between the high closing price during the period and the low closing price during the period, divided by the low price: High Price — Low Price/Low Price

   This variable is referred to as Hi-Lo.

A summary of the data used is as follows:

Inst. P & S	the dollar value of stock purchases and sales by major financial institutions.
T. Stk. Vol.	the total dollar value of stock volume on United States Securities Exchanges.
Perc. Inst. Tr.	institutional purchases and sales as a percent of total dollar volume.
PC S & P	percent change in S & P 500 Index during the period.
Abs. PC	the absolute value of the percent change in the S & P 500 Index during the period.
Hi-Lo	the difference between the high closing price and the low closing price during the period, divided by the low closing price.

We analyzed the correlations among the measures of institutional trading activity and the measures of stock price volatility. Those who hypothesize that institutional trading activity contributes toward an increase in stock price volatility would expect *significant positive* correlations between the alternative measures.

PRESENTATION OF RESULTS

Table 1 contains the basic descriptive statistics for the quarterly and annual data. These figures indicate a wide range of values for all the series involved.

TABLE 1

DESCRIPTIVE DATA FOR VARIABLES-
QUARTERLY AND ANNUAL OBSERVATIONS

	Mean	Std. Dev.	Max.	Min.
Quarterly Data (1/64 - 2/75)				
Inst. P & S	15.31	6.96	26.89	4.30
T. Stk. Vol.	37.32	11.32	56.83	14.83
Perc. Inst. Tr.	.395	.106	.565	.231
PC S & P	.007	.083	.216	-.261
Abs. PC	.061	.057	.261	.001
Hi-Lo	.106	.060	.334	.030
Annual Data (1962 - 1974)				
Inst. P & S	53.33	31.16	99.71	12.56
T. Stk. Vol.	135.62	52.43	206.02	56.75
Perc. Inst. Tr.	.365	.116	.522	.150
PC S & P	.006	.159	.201	-.297
Abs. PC	.137	.071	.297	.001
Hi-Lo	.256	.120	.602	.133

An important institutional activity variable is institutional purchases and sales as a percent of total trading volume. The quarterly data for this variable ranged from a low of about 23% (in 1965) to a high of about 56% (in 1970). The quarterly absolute percent change stock price figures ranged from almost no change (.001) to a 26% change. There was no secular pattern in the changes based upon an analysis of the time series. The range of hi-lo price changes is larger for annual changes as one might expect.

We can readily see that a significant range of values for all the variables prevailed during this period. This indicates that significant relationships among the variables can be derived *if the relationships exist.*

Table 2 shows that correlations among all the quarterly trading variables (Inst. P&S; Total Stock Volume; and Percent Inst. Trading) were in fact positive and statistically significant. *In contrast, the relationship among the institutional trading variables and the alternative measures of stock price volatility were generally either positive and statistically insignificant or negative and statistically insignificant.* The only exception was the correlation between the percent of institutional trading variable and the hi-lo volatility measure. This correlation of .28 is significant at the .05 level.

The correlations with the annual observations were consistent with the quarterly data results. The correlations among the alternative trading variables were large positive values and significant. Again, the correlations among the institutional trading variables and the stock price volatility measures did *not* support the folklore. Specifically, all the correlations among institutional purchases and sales and the three price volatility measures were *negative* but insignificant. Further, two of the three correlations with percent of institutional trading were also *negative* but insignificant. The only positive correlation was with hi-lo volatility and it was insignificant. Notably, the largest correlation was a negative value (−.250) between percent of institutional trading and percent change in the price index. While none of the correlations was statistically significant (with the number of observations the correlations had to be about .50 to be significant), note that *five of the six correlations were negative.* One would certainly be hard put to infer from this any support for the belief that a strong positive relationship exists between institutional trading and stock price volatility.

TABLE 2

CORRELATIONS AMONG MEASURES OF INSTITUTIONAL
TRADING AND MEASURES OF STOCK PRICE VOLATILITY

	Inst. P & S	T. Stk. Volume	Perc. Inst. Trading	PC S & P	Abs. PC	Hi-Lo
Quarterly Data						
Inst. P & S	---					
T. Stk. Volume	.875	---				
Perc. Inst. Trading	.845	.512	---			
PC S & P	.016	.003	-.041	---		
Abs. PC	-.076	-.136	.145	-.043	---	
Hi-Lo	.079	.025	.281	-.174	.817	---
Annual Data						
Inst. P & S	---					
T. Stk. Volume	.915	---				
Perc. Inst. Trading	.914	.707	---			
PC S & P	-.004	.052	-.250	---		
Abs. PC	-.104	-.070	-.106	-.263	---	
Hi-Lo	-.061	-.142	.206	-.779	.433	---

THE TIERED MARKET PROBLEM

As noted, the tiered equity market will probably be a relatively permanent part of our financial environment and thus has dire consequences for the many firms in the bottom tier. Specifically, firms with stock in the lower tier will experience *very poor* secondary markets for their stock because they will be of very little interest to the financial institutions who will be doing the majority of trading. Poor secondary markets imply poor marketability and liquidity for their shares, which will cause a substantial increase in their cost of new equity.

How, then, can we provide liquid secondary markets for small bottom tier firms in a market dominated by institutions? Put another way, how can one increase the trading in the common stock of small firms that presently are of no interest to large financial institutions that dominate trading in equity markets?

Most of the suggested solutions either attempt to increase participation by individual investors in the belief they can and will invest in these small firms, or they attempt to legislate against the large institutions to restrict their trading activities or make them small in the belief that small institutions will consider investing in small firms.

LIMIT PERCENT OF COMPANY OWNED

A relatively popular solution to the problem is to put a ceiling on the percent of any one company that a given financial institution can own. With a limit, institutions will supposedly be forced to own more stocks and may consider investing in small firms. The usual figure suggested is 10%. The effect of this proposal would obviously depend upon the size of the restriction — i.e., 10% or 2%. A 10% limit would have little effect on most institutions because very few institutions own anywhere near 10% of any of the companies in their portfolios. More important, few institutions would consider such a figure because they are vitally concerned with the liquidity of their holdings.

An obvious way to attain liquidity is to own a *small percent* of a stock that is widely traded. Under these conditions, when the institution wants to sell their total holding, it can be done without a major price adjustment. Hence, even if a stock is actively traded, an attempt to sell a substantial percent of the outstanding stock will cause a significant price adjustment. Therefore, for their own protection, institutions will normally not own more than 5% of even the most active stocks.

In contrast, with a limit of 2% the effect could be substantially different, because many institutions currently own more than this and other institutions would consider owning more than 2% for some large, active stocks. More important, one should consider whether this suggested solution might actually *increase* the problem.

Consider the following: if one assumes that institutions feel strongly about limiting the number of securities in their portfolio, such a requirement would *not* change the average value of each of the stocks in their portfolio, but would *increase* the required size of the companies they will consider. As an example, assume an institution with a $1 billion portfolio wanted to limit itself to a portfolio of fifty issues based upon the belief that this number would provide adequate diversification and minimize research and administration costs. Such a limit would imply an average holding of $20 million ($1 billion ÷ 50). If it is further assumed that the institution was willing to buy up to 5% of a company, the average required size of each company would be $400 million ($20 million ÷ .05). If the maximum percent of ownership was reduced to 2%, the average required size of each company *ceteris paribus* would become $1 billion ($20 million ÷ .02). Therefore, even *fewer* firms would qualify for the top tiers.

In addition to this undesirable scenario, consider the potential effects if the proposal is successful and causes institutions to increase the number of stocks in their portfolios. The first and most obvious effect is that the cost of research and administration for the portfolio will increase and, all else remaining the same, the returns to the clients of the institutions will decline. Further, one should seriously question whether an average increase in the number of issues from 50 to 100 or from 100 to 150 will cause the institutions to invest in bottom tier firms. Specifically, in the Reilly paper [21], it was estimated that there were about 700 firms that would qualify for the top tiers and there are about 8,600 companies in the bottom tier. Therefore, even if the institutions increase the number of issues, there are still many eligible firms to consider in the top tiers, and certainly *no* guarantee, nor even a very high probability, that the institutions will select the additional 50 or 100 issues from the bottom tier.

LIMIT DAILY TRANSACTIONS

Another suggestion is to limit the amount of stock that an institution could sell during a day or some other time interval. The logic of this suggestion and its expected benefits are obscure. Apparently, this requirement should reduce the number and the size of block trades made by institutions. Given this ultimate goal of reducing the number of block trades, one would expect that someone had found that block trades were disruptive to the market.

Yet, *no* evidence exists of a positive relationship between block trades and stock price volatility. In contrast, we can find some evidence that indicates a small *negative* relationship between block trades and stock price volatility.

Specifically, there was an analysis of the effect of block trades on the volatility of individual issues by Grier and Albin [7]. They related the daily price range for a sample of stocks (a measure of price volatility) to the trading volume in the stock and a dummy variable indicating a block trade. Based upon the significant *negative* coefficient for the block dummy variable, the authors concluded that the blocks had a *dampening* effect on the price variability.

In addition, Reilly analyzed the relationship between the aggregate amount of block trading and aggregate stock price volatility [22]. Any positive relationships were generally insignificant and the analysis found several instances in which a *strong negative* relationship prevailed between the percent of block volume and various measures of stock price volatility. Such evidence would indicate *no need* for such a restriction. In addition, such a trading constraint would obviously increase the costs to the institutions and reduce returns to their customers.

Further, one might even speculate that such a restriction would cause an *increase* in price volatility. Specifically, with such a restriction, a purchase or sale by an institution might be taken as a signal that further transactions might be forthcoming and other institutions might attempt to trade in anticipation of this. The result would be to *encourage* parallel trading by institutions that could cause an increase in volatility.

BREAK UP THE INSTITUTIONS

Should the large financial institutions be broken up into smaller institutions? This argument runs that, if the institutions are smaller, they will be able to invest in smaller firms — i.e., if the total portfolio is smaller, with a given number of stocks in the portfolio, the average value of each holding will be smaller; assuming a limit on the percent of the company owned, the value of the firms considered could be smaller.

Unfortunately, there are two major problems regarding this suggestion.

First, this solution ignores the significant economies of scale that exist in investment management. As an example, there are only slightly higher costs to managing a $2 billion account than the costs of managing a $1 billion account. Obviously, any such proposed break-up would result in substantially higher costs for all institutional customers.

Second, although the proposed break-up means that the smaller institutions *are able* to invest in smaller firms, what assurance have we that they will? Put another way, although the institutions are smaller, why wouldn't they continue to invest in top tier companies? The author knows of no study that has shown that small institutions tend to invest in smaller companies. Without such evidence, this suggestion entails very substantial costs to the customers of large financial institutions and apparently no certain benefits for companies in the bottom tier.

TAX INCENTIVES FOR INDIVIDUALS

Tax incentives for individual investors have been proposed, based upon the belief that if individual investors return to the stock market, they will invest in smaller, lower tier stocks.

Two problems exist for this suggestion. First, even with tax incentives, it is questionable whether individuals are willing to return to investing as individuals rather than through institutions. The second problem seems more critical — even with the tax incentives. Why will individual investors invest in lower tier stocks? Specifically, why wouldn't individuals feel that the better stocks are the institutional favorites? Therefore, unless the tax break were specifically limited to smaller firms, the individual investors would probably invest in top tier stocks. The administrative costs of a tax incentive restricted to a limited number of stocks would be prohibitive.

A MODEST ALTERNATIVE SUGGESTION

The following proposal is not fully developed regarding details, but is intended to provide an idea that has some merits for the prevailing environment. Notably, any proposed solution must recognize the additional risk and added costs of research and administration incurred by investors in lower tier stocks. Therefore, the proposal must include a package of incentives that will make such portfolio management saleable and profitable.

Simply stated, the government should provide tax incentives for *institutions* to establish mutual funds that will be *required* to invest in lower tier companies. The establishment of mutual funds to do the investing would recognize the trend toward investing through institutions. Then individuals might be willing to invest in small firms if an *institution* did the analysis, etc. — especially if tax incentives meant the mutual fund owners might receive an above average return.

To get the tax breaks (to be determined by a government agency), the "Small Business Fund" would have to invest in companies with market values of less than $200 million or $100 million (this is an approximation of where the lower tiers begin, because it is hard for institutions to invest in these companies).

The tax breaks should probably be similar to those given to Small Business Investment Companies.

These funds also should be allowed somewhat higher investment management fees to encourage the establishment of the funds. Also there should be legal protection against law suits because of commitments to high risk investments. The funds should be limited with regard to the proportion of a company they can own, but the percent should probably not be lower than 5% or it could create problems for the portfolio managers. Notably, the costs to the government of administering such a solution are substantially less for a limited number of mutual funds than several million individual stockholders.

CONCLUSION: DON'T NEGLECT THE MARKET!

Our large financial institutions and our capital markets have shown substantial ability to adapt to a changing environment — especially if economic incentives are provided. Prior to legislating against the institutions, there should be strong empirical proof that the institutions have caused the problem. The bulk of the empirical evidence to this point does *not* indicate that the institutions are the cause of any increase in stock price volatility. Therefore, any legislation in this area is unfounded. Regarding legislation to alleviate the tiered market problem, one should be convinced that it will provide the desired result. Apparently, most of the proposed solutions are inadequate in this regard. A major advantage of the proposed solution is that it provides an incentive and encourages the *market* to adapt.

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APPENDIX F
Statement of Harrison V. Smith

ANALYSIS OF WHETHER MORGAN GUARANTY'S
TRADING DETERMINES STOCK PRICES

In a paper entitled "Bank Trust Departments and Public Policy Today" (1) Professor Roy Schotland has suggested there is a point beyond which a single institutional investor accounts for so much buying or selling of stocks that the institutional investor cannot avoid setting the market price for those stocks. He further suggests that Morgan Guaranty has passed that point. In support of his contention, those stocks in which the bank's net purchases or sales for clients accounted for over 5% of annual trading volume in the respective shares for the years 1973, 1974, and 1975 were listed. Specifically, in 1975 there were 33 companies in which Morgan's net purchase for clients accounted for 5% or more of the total trading volume in those stocks. Likewise, there were 21 companies in which net sales for clients accounted for 5% or more of the total volume in those stocks. Similar data were presented for the years 1973 and 1974. The inference he drew is that, at least for the stocks indicated, Morgan Guaranty's activities on behalf of its clients resulted in setting the market prices for these stocks.

Professor Schotland has raised an important question. Specifically, does the fact that an institution may account for a sizable percentage of a stock's volume imply that the institution will have a measurable, and presumably adverse, impact on the stock's price? Our initial response would be to express doubt, since several generations of experience in the investment business show that customers tend to be happier when we buy low and sell high. That is, it is strongly in our own self interest to be sure that our trading for clients does not have any impact on market prices. Furthermore, in recent years our view has been shaped by conclusions such as those presented in the 1971 Study of Institutional Investors conducted by the Securities and Exchange Commission. This study concluded that "institutional trading overall has not impaired price stability in markets"(2). And that, "banks...tend to be price neutral: Their net trading imbalances tend to be in the opposite direction to price change as frequently as they are in the same direction"(3). Nevertheless, our respect for Professor Schotland and his deep interest in public policy issues relating to bank trust departments has led us to employ statistical tools in an effort to expand on his initial analysis of this matter. Specifically, we have sought to determine whether Morgan Guaranty's percentage of trading in the stocks he mentioned did, in fact, have an impact on the price behavior of these same stocks. A description of this effort and the overall conclusions are presented in the following sections. Subsequently, a somewhat more technical discussion of the statistical analysis is presented.

(1) Prepared for the Financial Institutions and the Nation's Economy (FINE) Study of the Committee on Banking, Currency and Housing, U.S. House of Representatives (June, 1976).
(2) Institutional Investor Study Report of the Securities and Exchange Commission (1971) Summary Volume, p. XXI.
(3) Op. cit., p. 84.

Brief Description of the Analysis

The stocks in which Morgan Guaranty's trading for clients accounted for a substantial portion of annual volume have been examined to see if there was any common trend in price change. Specifically, the analysis centered on companies in which the bank's net transactions accounted for over 5% of total volume in 1975 and 1976. This relationship was examined for the 33 net purchases and the 21 net sales in 1975 which Professor Schotland cited, as well as for all 94 stocks in which Morgan Guaranty's trading amounted to over 5% of total volume in 1976(4). (The study was confined to 1975 and 1976 since quarterly trading volume was not readily available for prior years.) Since trading was not necessarily continuous or evenly distributed throughout 1975 and 1976, the relationship between volume and share price movement was examined on a quarterly basis. That is, the proportion of quarterly volume accounted for by Morgan Guaranty's transactions was calculated for 54 stocks in 1975 and for 94 stocks in 1976. Subsequently, the quarterly price changes for these same stocks was derived. These price changes were than adjusted to remove the effect of price movement trends for the stock market as a whole - a factor which typically explains 30%-40% of a single stock's price variability. For example, where a stock rose 15% and the S.&P. rose 10%, the market-adjusted price change would be 5% (15% minus 10%). These data are presented graphically in Charts 1 through 16, which are attached and further described.

Conclusions

Visual examination of these data provides little evidence that there has been any meaningful relationship between the percent of a stock's trading attributed to Morgan Guaranty and its price behavior. For the most part, the data appear wildly behaved and generally unpredictable. Statistical analysis of the data, discussed in the subsequent section, confirms this visual examination. We have not been able to find any relationship between percentage changes in price and the fraction of trading that Morgan accounts for. Consequently, we conclude very strongly that Morgan Guaranty has not, in fact, set prices for this group of stocks.

We would further note that this test has been limited to those stocks in which Morgan Guaranty's 1975 and 1976 trading activity has been described as substantial. As such, the group of stocks is not representative of the bank's overall trading activity. In fact, it dramatically overstates Morgan Guaranty's overall presence in the trading of common stocks, which amounted to only 2%-3% of total N.Y.S.E. volume in 1975.

The overall conclusion is not surprising in light of the generally held belief that domestic security markets are reasonably efficient. For this to be so, there must be a willing seller of every share Morgan Guaranty, or any other investor, wishes to purchase and a willing buyer for every share Morgan Guaranty wishes to sell. Furthermore, the conclusion is quite consistent with policies our traders have followed for many years, namely, that every effort should be made to ensure that the bank's transactions for clients do not impact securities prices.

(4) Morgan Guaranty's quarterly volume was extracted from the "Spectrum Reports" of Computer Directions Advisors, Inc.; New York Stock Exchange volume data were provided by Compustat.

Summary of Statistical Analysis

The objective in the various analyses we have done is to attempt to test the hypothesis suggested by Professor Schotland that our equity trading above 5% of the volume in some sense "determines" price.

Professor Schotland's concern was qualitatively stated; he did not specify a particular mathematical equation for this "determining" relationship and so we have applied various plausible particular model specifications. We used linear regression models based on ordinary least squares. The formal statistical tests of significance are based upon the assumption that the dependent and independent variables are jointly normally distributed. All the models we tested exhibited great instability in the coefficients from quarter to quarter and between purchases and sales. We modeled purchases and sales both separately and together.

We have not been able to find any relationship between percentage changes in price and the fraction of trading volume that we have accounted for in our purchasing and selling programs which would appear to be meaningful.

The combined purchases and sales data are displayed in Charts 1-8. The data presented in these charts are quarterly data. The first four charts are for the four quarters of 1975, the last four are for 1976. The variable labeled "Y axis" is the percentage change in equity price normalized by the simultaneous percentage change in market price (P). The variable labeled "X axis" is the percentage of trading volume accounted for by Morgan Guaranty (M). We adopt the convention that buying volume is positive and selling volume is negative. The letters in the charts are symbols for individual companies. The numerals show coincident data points, a "2" for two such points, a "3" for three, etc.

In the cases - a distinct minority - where coefficients appear to be "significant," we find that the coefficients are very sensitive to the presence or absence of a small number of outliers. This is a very familar problem in the statistical analysis of data which is non-normal because of astationarity or contamination of the process. For example, in testing the model:

$$P = a + bM$$

on combined purchases and sales with data for the second quarter of 1975 shown in Chart 2, we found that b = .17 with a t-statistic of 2.1. However, when we stripped outliers for M above 41% and P greater than 20% or less than -20%, we found that b = .07 with a t-statistic of 1.4 (not significant at the 95% confidence level).

The coefficients are not consistent even with respect to sign. In the most recent year 1976, the coefficient of the volume term is positive in the scatter diagram shown in Chart 5. On the other hand, using the same model, in the third quarter of 1976 which is shown in Chart 7, the coefficient is negative which implies that the "effect" of Morgan's trading is the opposite of what Professor Schotland would expect. Charts 3 and 4 for the third and fourth quarters of 1975 appear to show no relationship at all.

Charts 9 through 16 show purchases and sales separately for the year 1975 - the most recent year on which Professor Schotland focused. Again using the model:

$$P = a + bM$$

as an example, we find no significant relationship except for Chart 13, first quarter sales, which shows a positive relationship. If one strips the outliers below M = -15%, the coefficient on M becomes insignificant.

Inspection of these charts leads us to believe that no meaningful relationship in fact exists. If the Committee should care to pursue this investigation further, we shall be happy to offer further assistance.

CHART 1

Net % Stock Price Change Vs. Morgan's % Trading Volume: First Quarter 1975, Buys and Sells Combined

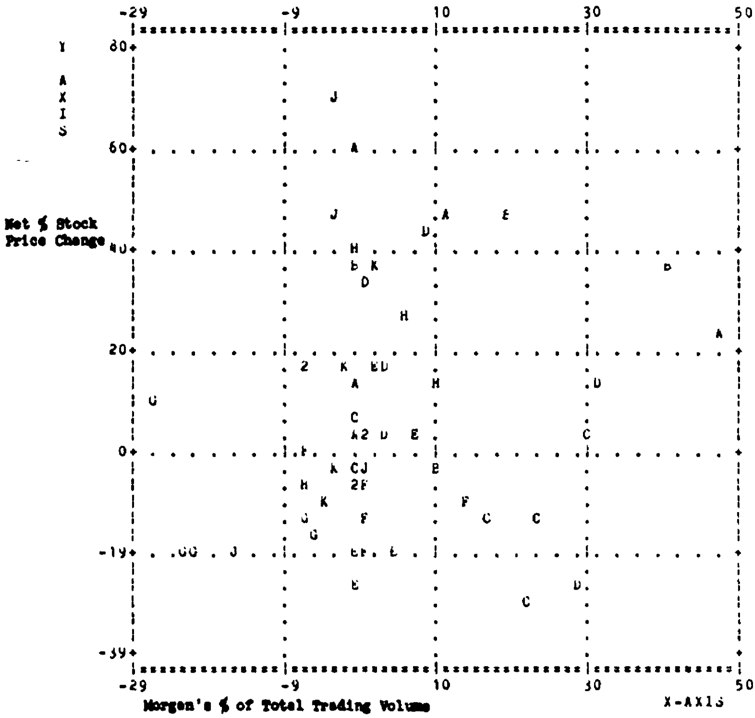


CHART 2

Net % Stock Price Change Vs. Morgan's % Trading Volume: Second Quarter 1975, Buys and Sells Combined

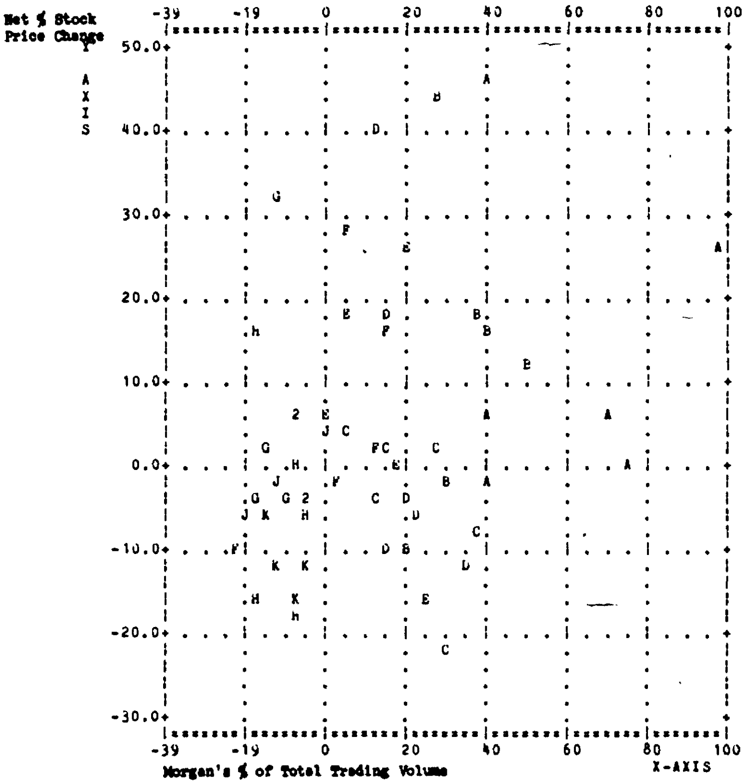


CHART 3

Net % Stock Price Change Vs. Morgan's % Trading Volume:
Third Quarter 1975, Buys and Sells Combined

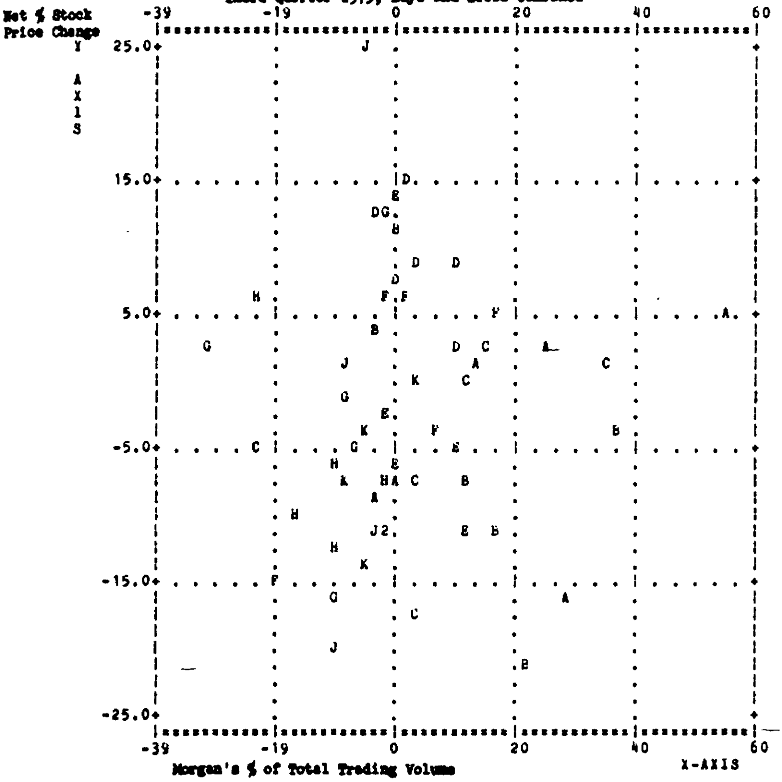


CHART 4
Net % Stock Price Change Vs. Morgan's % Trading Volume:
Fourth Quarter 1975, Buys and Sells Combined

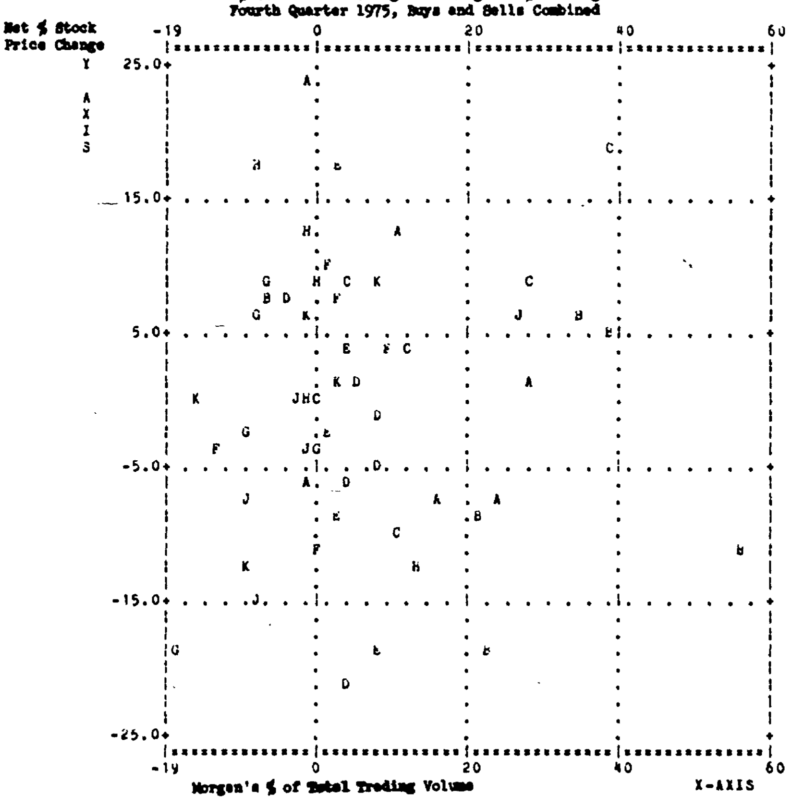


CHART 5

Net % Stock Price Change Vs. Morgan's % Trading Volume: First Quarter 1976, Buys and Sells Combined

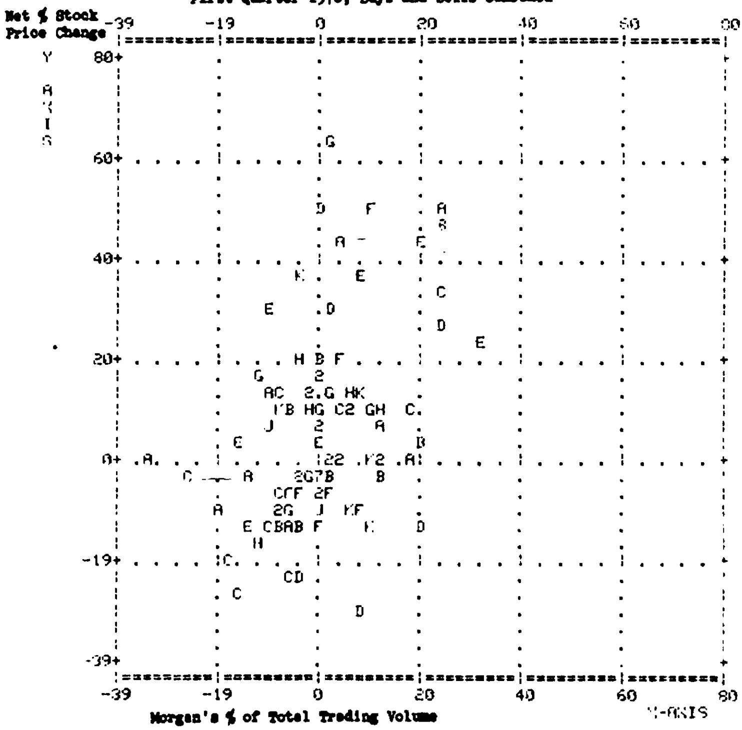


CHART 6

Net % Stock Price Change Vs. Morgan's % Trading Volume: Second Quarter 1976, Buys and Sells Combined

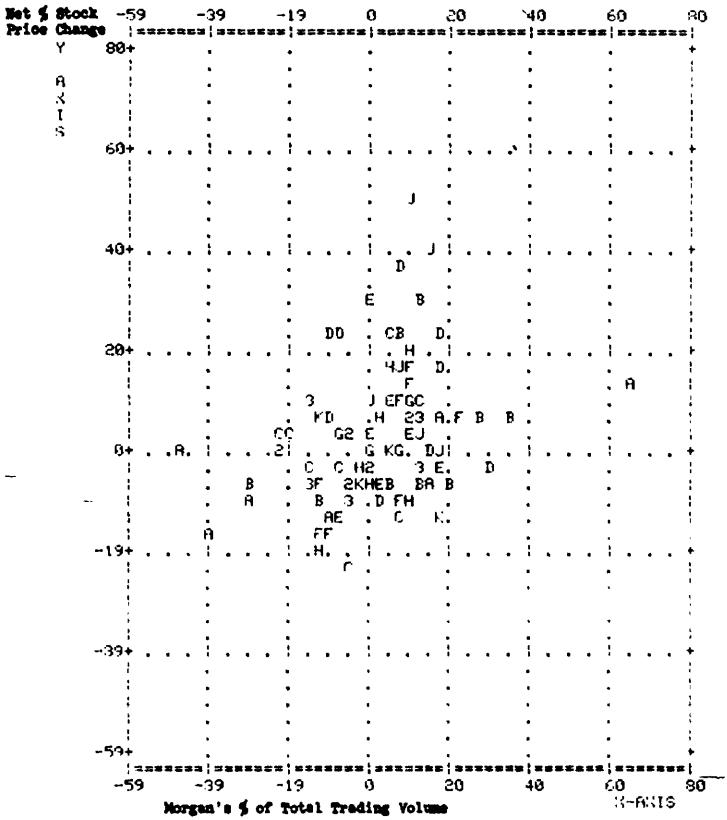


CHART 7

Net $ Stock Price Change Vs. Morgan's $ Trading Volume: Third Quarter 1976, Buys and Sells Combined

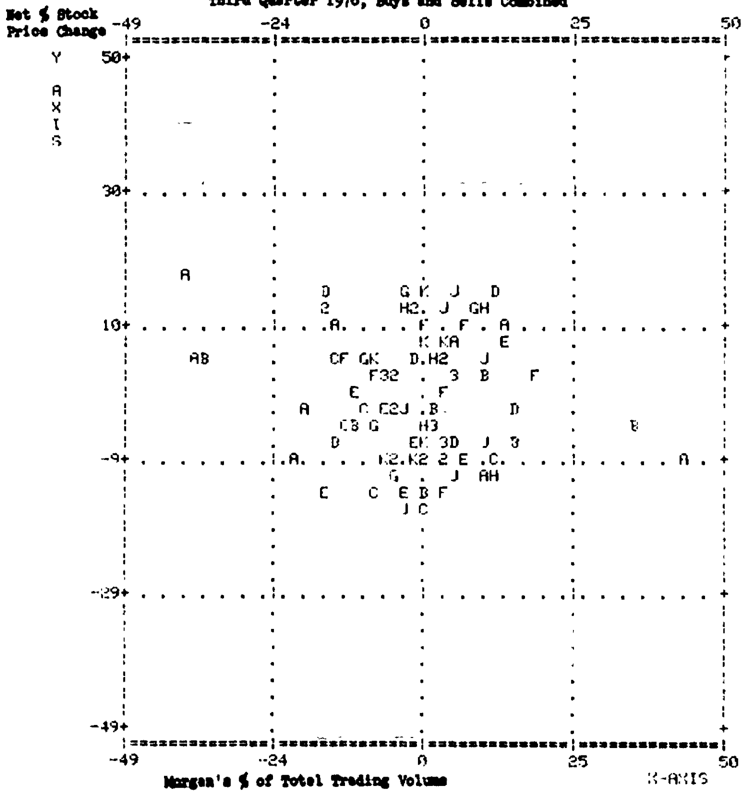


CHART 8

Net % Stock Price Change Vs. Morgan's % Trading Volume: Fourth Quarter 1976, Buys and Sells Combined

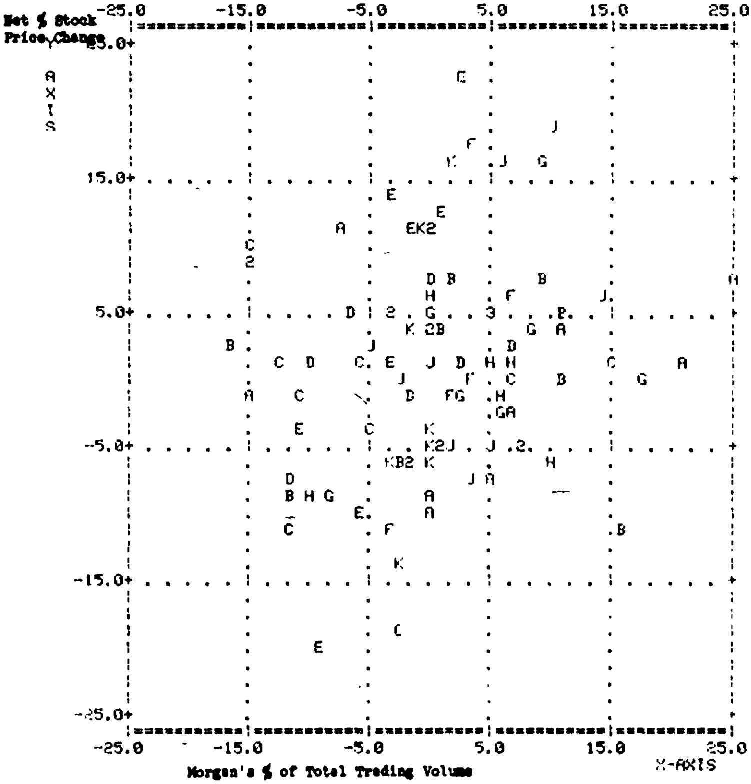


CHART 9

Net % Stock Price Change Vs. Morgan's % Trading Volume: First Quarter 1975 Buys Only

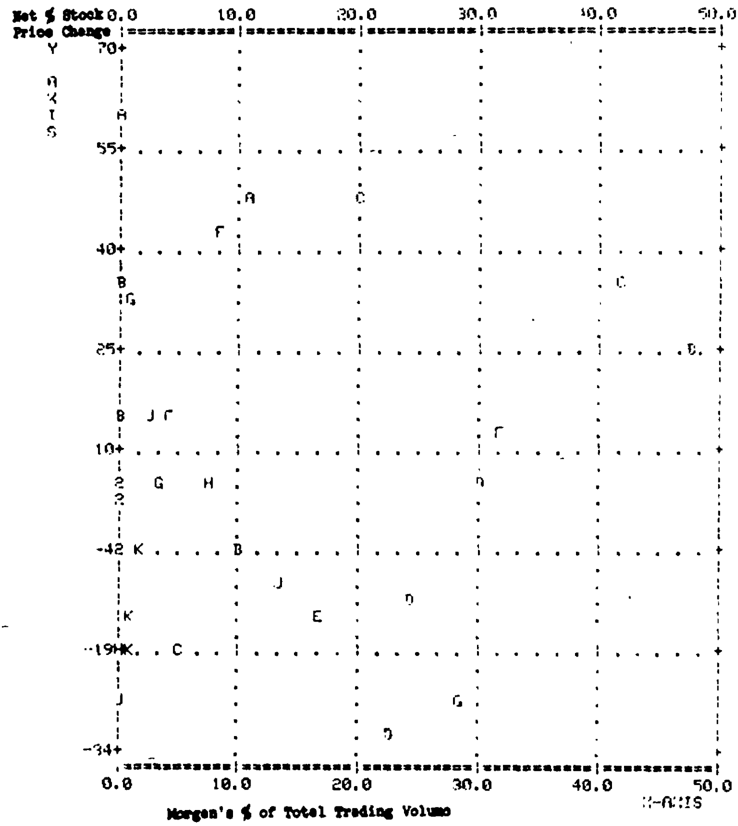


CHART 10

Net % Stock Price Change Vs. Morgan's % Trading Volume: Second Quarter 1975, Buy Only

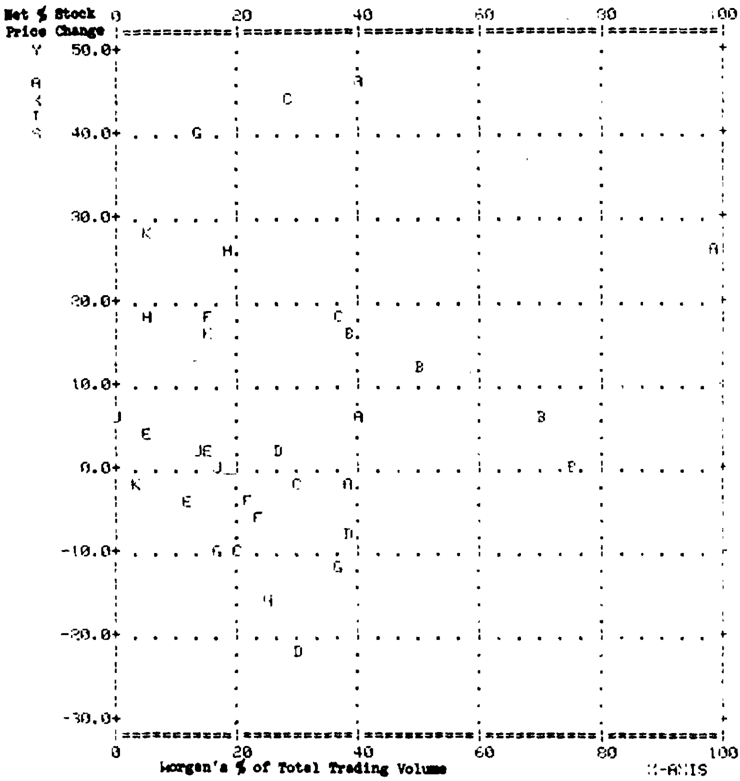


CHART 11

Net % Stock Price Change Vs. Morgan's % Trading Volume: Third Quarter 1975, Buy Only

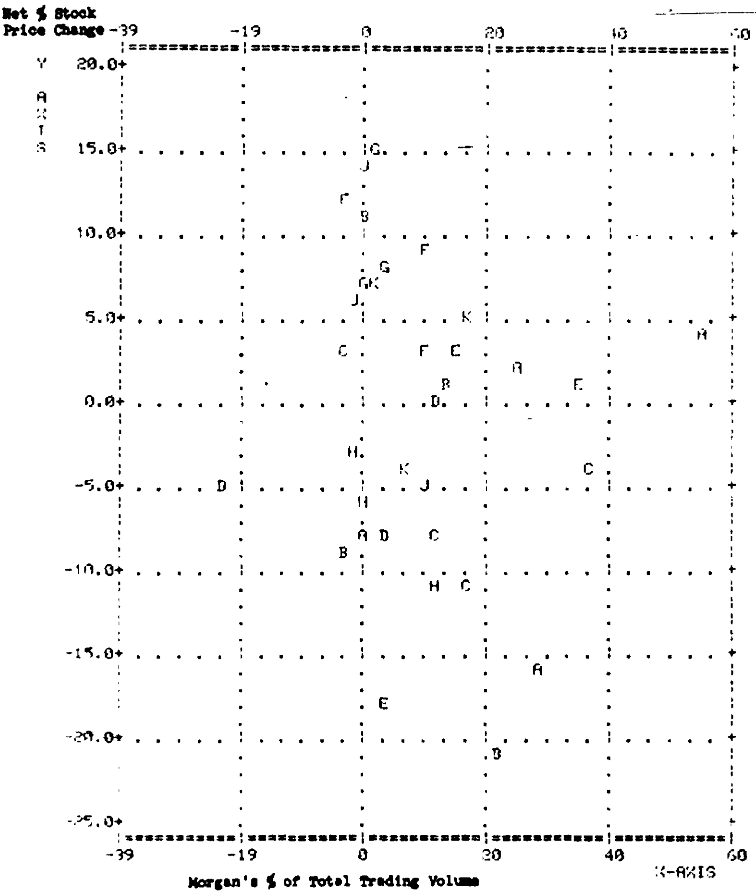


CHART 12

Net % Stock Price Change Vs. Morgan's % Trading Volume: Fourth Quarter 1975, Buy Only

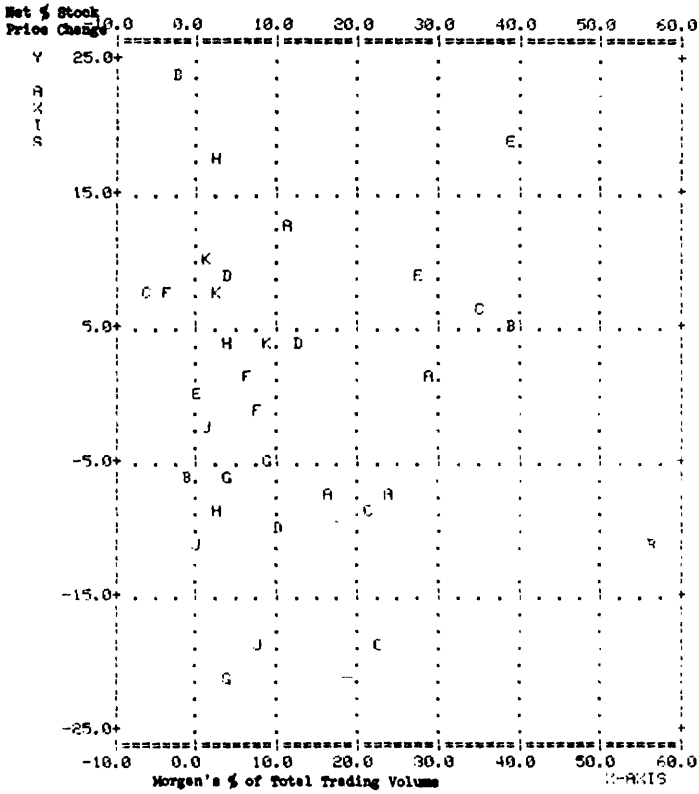


CHART 13

Net % Stock Price Change Vs. Morgan's % Trading Volume: First Quarter 1975, Sell Only

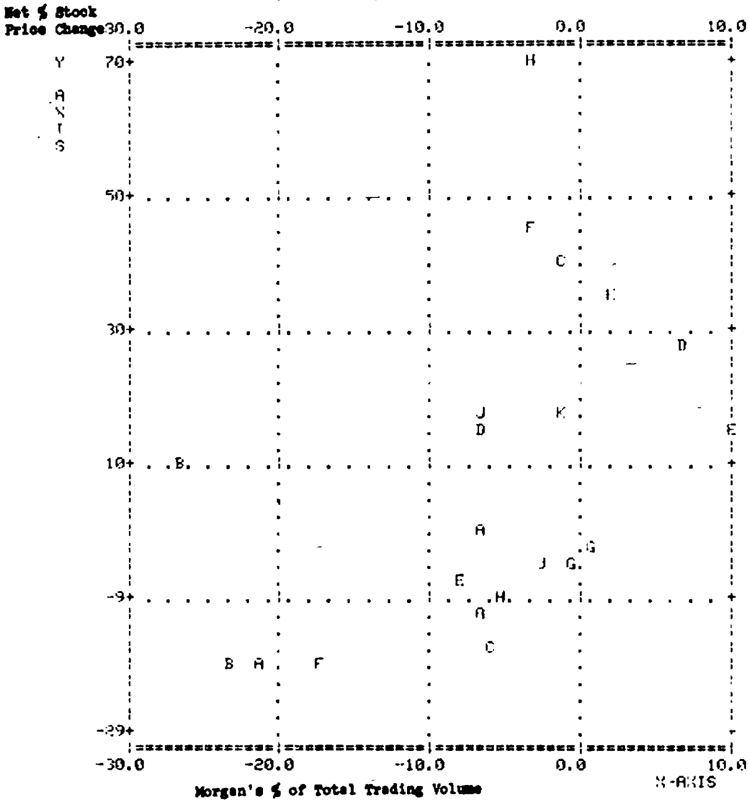


CHART 14

Net % Stock Price Change Vs. Morgan's % Trading Volume: Second Quarter 1975, Sell Only

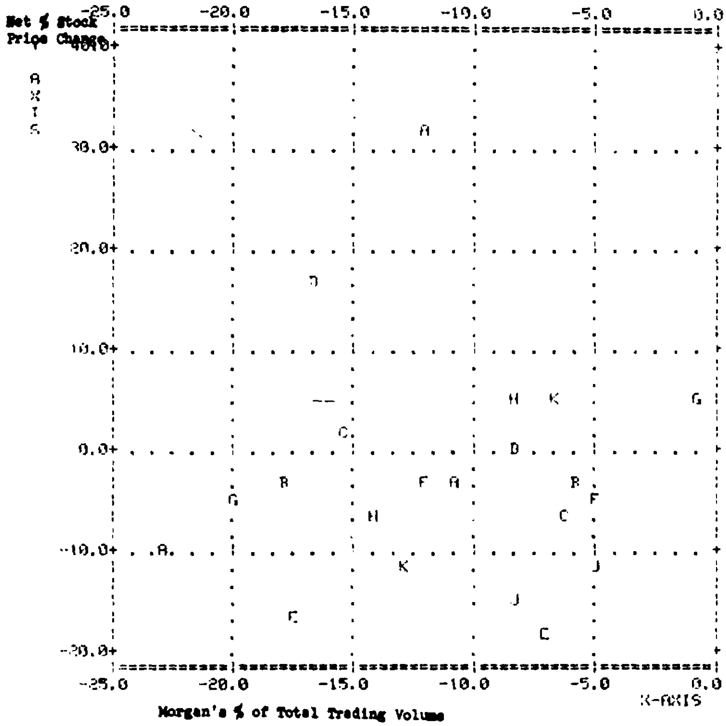
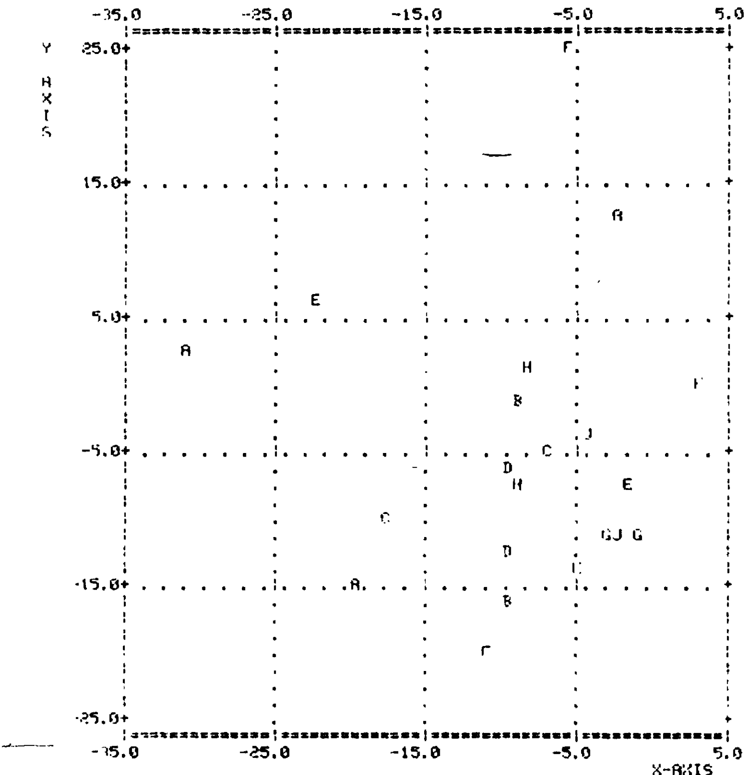


CHART 15

Net % Stock Price Change Vs. Morgan's % Trading Volume: Third Quarter 1975, Sell Only

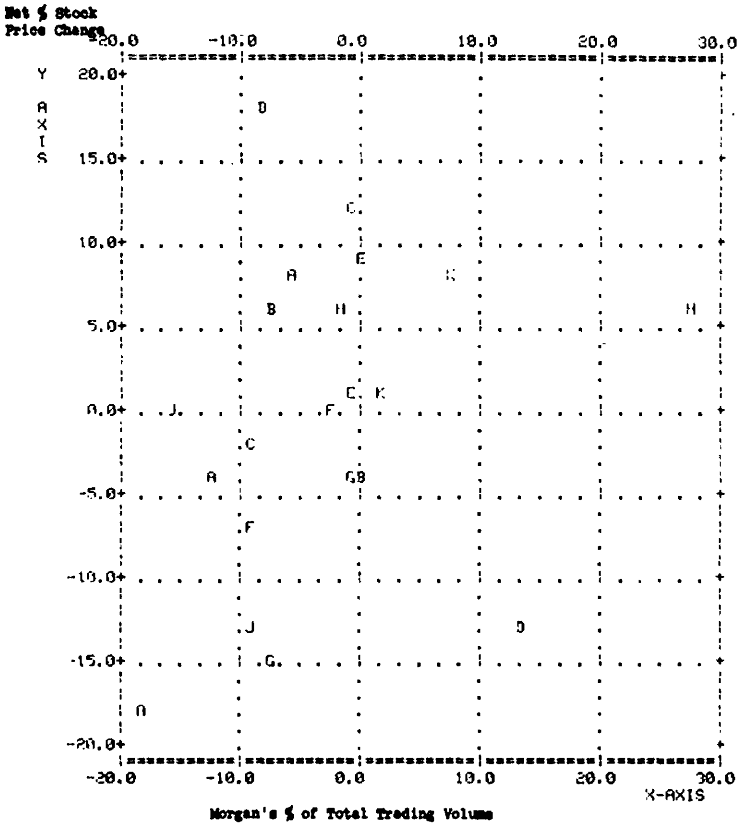
Net % Stock Price Change



Morgan's % of Total Trading Volume

CHART 16

Net % Stock Price Change Vs. Morgan's % Trading Volume: Fourth Quarter 1975, Sell Only



Senator BENTSEN. Our next two witnesses are Mr. C. V. Wood, Jr., chairman of McCulloch Oil Co., Los Angeles, Calif.; and Mr. Maurice Krug, chairman of Technology, Inc., Ohio.

Would you gentlemen please come forward?

We are delighted to have you back. This is 1977. In July 1973, Mr. Wood, you were testifying before this committee about the enormous capital needs facing our economy. You and I were voices in the wilderness at that time.

I fully agreed with you then. There were not too many people listening in 1973 about the capital shortage, but we have gained considerable support since then. In fact, President Carter has promised that the administration's tax reform bill will include major incentives for capital formation.

I believe that there is strong support in the Congress for incentives. We have come a long way since July 1973 in gaining that support. I hope now that we can reap some of the benefits of it by some actual legislation that comes to fruition.

I welcome you again and I want to thank you for the strong support that you have given to my pension simplification and pension investment bills.

STATEMENT OF C. V. WOOD, JR., CHAIRMAN, McCULLOCH OIL CO.

Mr. WOOD. Thank you, Senator. I would like to say that you have been a great friend of the small- and medium-sized companies and your staying up here fighting and trying to help us keep us all going.

I am grateful to you for your consideration of the extremely important matters before you, and for giving me an opportunity to be heard.

I am C. V. Wood, Jr., chairman of McCulloch Oil Corp., but I appear here as chairman of the Committee of Publicly Owned Companies. With me today is Maurice F. King, chairman of Technology, Inc., who, with your permission, will make a short statement following my remarks.

I believe some or all of you are familiar with the Committee of Publicly Owned Companies. It is composed of about 700 chief executives of corporations located in practically every State of the Union. Most of our members are small- or medium-sized companies, but some large companies like Chrysler, ITT, GTE, and LTV have joined us because they share our concern.

Our companies employ more than 2.8 million workers and account for $140 billion in sales. They are deeply concerned about the need for equity capital in order to continue to produce the goods and services and to supply the jobs that America needs.

I think I may fairly say that the Committee of Publicly Owned Companies, some years ago, was in the forefront of those who began to call attention to the national problem of capital formation, particularly to the inadequacies of available equity capital. I think we may share in the feeling of gratification that there is now general agreement that this problem exists and that reforms of tax laws and fiscal policies are needed if we are going to provide the goods and services and jobs necessary for our country.

Your committees are today considering vital aspects of this problem. You are considering the chief vehicle in our Nation that determines how capital, once it has been accumulated, is allocated; namely, the private pension plans. As you know, the total assets of private pension plans now exceed $450 billion, and about $30 billion of new money goes into these money pools each year.

Under the leadership of some of the members of your committees, the Congress has quite properly enacted legislation to govern the management of the enormous assets in the private pension funds and to assure that the workers—their intended beneficiaries—receive the full benefit of those assets, as the pension plans intended. But in so doing, some unnecessary complications have been created and some adverse, unintended results have followed. I am delighted that your committees are now addressing themselves to these matters.

S. 901, introduced by Senator Bentsen, addresses itself to a problem which more than any other has discouraged businesses from adopting pension plans and has caused the abandonment of some of them. This is the incredible complexity and confusion of the jurisdictional and reporting requirements of ERISA.

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S. 901 corrects some of the burdens of dual jurisdiction in the Treasury and Labor Departments which has resulted in conflicts, inconsistencies and duplications serving no purpose except confusion, aggravation, and expense. The bill will also reduce the number of reports and paperwork required by ERISA—a move which all of us who are gradually drowning in a sea of paper will applaud. After all, ERISA is not a bill for relief of lawyers and accountants, nor was it supposed to be a mandate to destroy our forests in order to produce paper. I am confident that the entire business community applauds S. 901 and will be grateful to you for its speedy enactment.

S. 285, also introduced by Senator Bentsen, is, in our strongly held view, a measure of the greatest urgency and of fundamental importance. A wholly unintended result of ERISA has been to encourage the diversion of the huge pension fund assets to companies that have the least need for them, and to starve the smaller and medium-sized companies that desperately need access to equity capital.

This has come about largely because of apparently sensible provisions in ERISA designed to impose high standards of conduct on the fiduciaries responsible for administering the pension plans. Basically, the trouble stems from the "prudent man" rule of section 404 of the act coupled with the formidable penalties provisions to which the act subjects fiduciaries.

For example, sections 405 and 409 make fiduciaries liable to make good any losses resulting from a breach of duty and provides that one fiduciary may be liable for the acts or omissions of a fellow-fiduciary.

Now, I want at the outset to make it clear that we do not object to the requirement that a fiduciary must act prudently, or that he is responsible for his acts. On the contrary, what is needed—and what

S. 285 attempts to supply—is to make clear that the act permits and, indeed, encourages fiduciaries to invest pension funds in a manner that we believe will be in the greater interest of the beneficiaries of the pension plans, and which will certainly be in the greater national interest.

At the present time, the vast preponderance of pension plan funds is being invested in the securities of blue-chip companies—in a few "religion" stocks—and in fixed-interest securities—corporate debt obligations. The effect of this is pervasive.

First, smaller companies—the red and white chips—are starving. Their value, as measured by the stock market value of their securities—is vastly diminished because of the absence of money to buy their equities. Because investment of pension plan moneys is largely confined to the glamour stocks, the market value of these stocks are increased.

Since pension fund managers do not buy the stocks of smaller or less known companies, the market value of those stocks is drastically reduced.

Here is the dramatic evidence of that fact—the Value Line index, that includes stocks of smaller companies as well as the blue chips—declined 31 percent between 1966 and 1976; the Dow Jones average, including only blue chips, increased by 14 percent.

The result of this is to lower the market value of the securities of the second tier companies and to decrease their ability to get financing from banks or anywhere else, and actually to foreclose them from equity financing. The result is also to make them vulnerable to raids in the form of tender offers. The members of our committee can supply you with graphic details about this and its destructive effects.

Second. Smaller companies are not able to update their plant and equipment or to expand in order to supply the jobs America needs. In this connection, I want to urge you to consider recent studies by the MIT Development Foundation and the Commerce Technical Advisory Board which show that it is these companies—young, smaller, more aggressive—that are the most effective in supplying new jobs, and that their ability to do so is relatively much greater than the blue chips.

I am attaching a summary of the conclusions of these studies as exhibit A to my statement, and I ask that this and an editorial comment, exhibit B, be received in evidence.

Third. The concentration of available funds in the religion or glamor stocks, and the neglect of the stocks of smaller and less glamorous companies is increasing—not decreasing—despite the enormous amounts that are annually added to pension funds. I attach a Wall Street Journal summary as exhibit C on the increase in bank holdings of such stocks.

I also want to call your attention to the ominous fact that only 658 new issues of common stock were marketed in 1974, 1975, and 1976 compared to 2,922 new issues in 1971, 1972, and 1973—a sure indication that smaller companies are not getting equity capital. This is also shown by the fact that corporate debt-equity ratios have increased from 24 percent in 1960 to 43 percent in 1975—a fact which demonstrates the dangers in the present situation and which, again, indicates that smaller, less glamorous companies are not getting the equity capital flow that they need.

Now, there is no doubt that the prudent man rule of ERISA has contributed to this situation—or rather, that the construction placed on that rule or the fear which it has introduced, has done so. As SEC Chairman Williams remarked in a recent interview:

> ERISA's standards of fiduciary responsibility have spawned a defensiveness among pension fund managers that is having a major reallocation effect. By and large, the losers are small, thinly capitalized issuers.

Exhibit D to this statement includes additional observations to this effect.

S. 285 proposes two measures to deal with this problem: first, it would, in effect, require managers of the largest pension funds to invest in no more than 5 percent of the outstanding stock of any company with a capitalization of $150 million or more. This proposal would tend to prevent further concentration in a few glamour companies, and thereby encourage diversification.

Second, the fill would expressly provide that a fiduciary does not violate the prudent man rule of ERISA or any other law solely because it invests up to 2 percent of the assets of the trust in the securities of any corporation with a capital account of less than $25 million.

Both of these proposals would, in our view, represent commendable measures in the direction of encouraging a more flexible and expansive usè of pension funds and would provide a signficant measure of relief from a situation which we believe is not in the interest of either fund beneficiaries or the Nation.

We believe that investment in red and white chip companies would provide a real measure of diversification for the protection of beneficiaries who may otherwise suffer by a decline in the value or yield of glamour stocks.

It would also increase the ultimate returns to the beneficiaries, because the yield from well-selected red and white chip securities—both debt and equity—may well be greater than from the glamour securities. And we know that all of us will suffer unless some of these vast funds are directed to the younger, vigorous and job-creating companies of our Nation.

We endorse Senator Bentsen's bill, but as your committees proceed to consider the specific measures which should be incorporated in the bill, we would like you to consider the following additional suggestions.

First, we propose that the prudent man rule should be amended so as to provide explicitly that determination of the prudence of the investment judgment of fiduciaries should be based upon the total portfolio rather than upon the quality of each individual investment. This would expressly encourage a reasonable amount and degree of investment in securities of less mature companies which involve some degree of risk-taking.

Second, we propose that the stated objective of ERISA should be amended to declare as the national policy that there tax-exempt funds should be invested in a diverse selection of American companies, covering the entire spectrum and including those that are smaller or less seasoned, so that the capital which the funds have accumulated will promote the growth and development of innovative and competitive business entities.

I want to thank you and members of the committee for the opportunity to be here before you. I will be happy to try to answer any questions you might have.

Senator BENTSEN. Mr. Wood, we have several committees meeting today, unfortunately. We have gone through a reorganization of the Senate to bring us a great deal more efficiency, and now I have three committees meeting at the same time, rather than five. That is one of the problems that we do run into here.

[The prepared statement of Mr. Wood follows. Oral testimony continues on p. 350.]

STATEMENT OF C. V. WOOD, JR., ON BEHALF OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES

Mr. Chairman and Members of the Committees: I am grateful to you for your consideration of the extremely important matters before you ,and for giving me an opportunity to be heard.

I am C. V. Wood, Jr., Chairman of McCulloch Oil Corporation, but I appear here as Chairman of The Committee of Publicly Owned Companies. With me today is Mr. Maurice F. Krug, Chairman of Technology, Inc., who, with your permission, will make a short statement following my remarks.

I believe some or all of your are familiar with The Committee of Publicly Owned Companies. It is composed of about 700 Chief Executives of corporations located in practically every State of the Union. Most of our members are small- or medium sized companies, but some large companies like Chrysler, ITT, GTE and LTV have joined us because they share our concerns.

Our companies employ more than 2.8 million workers and account for $140 billion in sales. They are deeply concerned about the need for equity capital in order to continue to produce the goods and services and to supply the jobs that America needs.

I think I may fairly say that The Committee of Publicly Owned Companies, some years ago, was in the forefront of those who began to call attention to the national problem of capital formation, particularly to the inadequacies of available equity capital. I think we may share in the feeling of gratification that there is now general agreement that this problem exists and that reforms of tax laws and fiscal policies are needed if we are going to provide the goods and services and jobs necessary for our Country.

Your Committees are today considering vital aspects of this probelm. You are considering the chief vehicle in our Nation that determines how capital, once it has been accumulated, is allocated; namely: The Private Pension Plans. As you know, the total assets of Private Pension Plans now exceed $450 billion, and about $20 billion of new money goes into these money-pools each year.

Under the leadership of some of the members of your Committees, the Congress has quite properly enacted legislation to govern the management of the enormous assets in the private pension founds and to assure that the workers—their intended beneficiaries—receive the full benefits of those assets, as the Pension Plans intended. But in so doing, some unnecessary complications have been created and some adverse, unintended results have followed. I am delighted that your Committees are now addressing themselves to these matters.

S. 901, introduced by Senator Bentsen, addresses itself to a problem which more than any other has discouraged business from adopting Pension Plans and has caused the abandonment of some of them. This is the incredible complexity and confusion of the jurisdictional and reporting requirements of ERISA.

S. 901 corrects some of the burdens of the dual jurisdiction in the Treasury and Labor Department which has resulted in conflicts, inconsistencies and duplications serving no purpose except confusion, aggravation and expense. The Bill will also reduce the number of reports and paper work required by ERISA—a move which all of us who are gradually drowning in a sea of paper will applaud. After all, ERISA is not a Bill for relief of lawyers and accountants, nor was it supposed to be a mandate to destroy our forests in order to produce paper. I am confident that the entire business community applauds S. 901 and will be grateful to you for its speedy enactment.

S. 285, also introduced by Senator Bentsen, is, in our strongly-held view, a measure of the greatest urgency and of fundamental importance. A wholly unintended result of ERISA has been to encourage the diversion of the huge pension fund assets to companies that have the least need for them, and to starve the smaller medium sized companies that desperately need access to equity capital. This has come about largely because of apparently sensible provisions in ERISA designed to impose high standards of conduct or the fiduciaries responsible for administering the Pension Plans. Basically, the trouble stems from the "prudent man" rule of Section 404 of the Act coupled with the formidable penalties provisions to which the Act subjects fiduciaries. For example, Sections 405 and 409 make fiduciaries liable to make good any losses resulting from a breach of duty and provides that one fiduciary may be liable for the acts or omissions of a fellow-fiduciary.

Now, I want at the outset to make clear that we do not object to the requirement that fiduciary must act prudently, or that he is responsible for his acts. On the contrary, what is needed—and what S. 285 attempts to supply—is to make clear that the Act permits and indeed, encourages, fiduciaries to invest pension funds in a manner that we believe will be in the greater interest of the beneficiaries of the Pension Plans, and which will certainly be in the greater national interest.

At the present time, the vast preponderance of pension plan funds is being invested in the securities of blue-chip companies—in a few "religion" stocks—and in fixed-interest securities—corporate debt obligations. The effect of this is pervasive.

First: Smaller companies—the red and white chips—are starving. Their value, as measured by the stockmarket value of their securities—is vastly diminished because of the absence of money to buy their equities. Because investment of pension plan monies is largely confined to the glamour stocks, the market value of these stocks are increased. Since previous fund managers don't buy the stocks of smaller or less known companies, the market value of those stocks is drastically reduced.

Here's dramatic evidence of that fact—the Value Line index, that includes stocks of smaller companies as well as the blue chips—declined 31 percent between 1966 and 1976; the Dow Jones average, including only blue chips, increased by 14 percent.

The result of this is to lower the market value of the securities of the second tier companies and to decrease their ability to get financing from banks or anywhere else, and actually to foreclose them from equity financing. The result is to make them vulnerable to raids in the form of tender offers. The members of our Committee can supply you with the graphic details about this and its destructive effects.

Second: Smaller companies are not able to up-date their plant and equipment or to expand in order to supply the jobs America needs. In this connection, I want to urge you to consider recent studies by the MIT Development Foundation and the Commerce Technical Advisory Board which show that it is *these* companies—young, smaller, more aggressive—that are the most effective in supplying new jobs, and that their ability to do so is relatively much greater than the blue chips. I am attaching a summary of the conclusions of these studies as Exhibit A to my statement, and I ask that this and an editorial comment, Exhibit B, be received in evidence.

Third: The concentration of available funds in the religion or glamour stocks, and the neglect of the stocks of smaller and less glamorous companies is increasing—not decreasing—despite the enormous amounts that are annually added to the pension funds. I attach a *Wall Street Journal* summary as Exhibit C on the increase in bank holdings of such *stocks*.

I also want to call your attention to the ominous fact that only 658 new issues of common stock were marketed in 1974, '75 and '76, compared to 2,922 new issues in 1971, '72 and '73—a sure indication that smaller companies are not getting equity capital. This is also shown by the fact that corporate debt-equity ratios have increased from 24 percent in 1960 to 43 percent in 1975—a fact which demonstrates the dangers in the present situation and which, again, indicates that smaller, less glamorous companies are not getting the equity capital flow that they need.

Now, there is no doubt that the "prudent man" rule of ERISA has contributed to this situation—or rather, that the construction place on that rule or the fear which it has induced, has done so. As SEC Chairman Williams remarked in a recent interview: "ERISA's standards of fiduciary responsibility have spawned a defensiveness among pension fund managers that is having a major reallocation effect. By and large, the losers are small, thinly capitalized issuers." Exhibit D to this statement includes additional observations to this effect.

S. 285 proposes two measures to deal with this problem: *First*, it would, in effect, require managers of the largest pension funds to invest in no more than five percent of the outstanding stock of any company with a capitalization of $150 million or more. This proposal would tend to prevent further concentration in a few glamour companies, and thereby encourage diversification. *Second*, the Bill would expressly provide that a fiduciary does not violate the "prudent man" rule of ERISA or any other law solely because it invests up to two percent of the assets of the trust in the securities of any corporation with a capital account of less than $25,000,000.

Both of these proposals would, in our view, represent commendable measures in the direction of encouraging a more flexible and expansive use of pension funds and would provide a significant measure of relief from a situation which we believe is not in the interest of either fund beneficiaries or the Nation. We believe that investment in red and white chip companies would provide a real measure of diversification for the protection of beneficiaries who may otherwise suffer by a decline in the value or yield of glamour stocks. It would also increase the ultimate returns to the beneficiaries, because the yield from well-selected red and white chip securities—both debt and equity—may well be greater than from the glamour securities. And we know that all of us will suffer unless some of these vast funds are directed to the younger, vigorous and job-creating companies of our Nation.

We endorse Senator Bentsen's Bill, but as your Committees proceed to consider the specific measures which should be incorporated in the Bill, we would like you to consider the following additional suggestions:

First: We propose that the "prudent man" rule should be amended so as to provide explicitly that determination of the prudence of the investment judgment of fiduciaries should be based upon the total portfolio rather than upon the quality of each individual investment. This would expressly encourage a reasonable amount and degree of investment in the securities of less-mature companies which involve some degree of risk-taking.

Second: We propose that the stated objective of ERISA should be amended to declare as the national policy that these tax-exempt funds should be invested in a diverse selection of American companies, covering the entire spectrum and including those that are smaller or less-seasoned, so that the capital which the funds have accumulated will promote the growth and development of innovative and competitive business entities.

Third: We suggest that the committees consider whether Section 3 of S. 285 should be amended as follows: (1) To broaden the category to which it relates by increasing the maximum capital account of companies to which it relates from $25 million to $50 million, and (2) by removing the two percent limitation.

The effect of this would be merely to provide that in appraising the investment prudence of fund managers, the *mere fact* that they have invested in smaller companies, as defined, would not be considered as evidence of a failure to satisfy the "prudent man" standard. This would not be giving the managers a blank check. The conservatism or lack of thereof of the entire portfolio would still be subject to scrutiny on a "prudent man" basis; but the *mere fact* that investments have been made in companies of $50 million capital or less would not, in and of itself, be considered to indicate a departure from this standard.

We suggest the $50 million target figure rather than the $25 million figure because, in these days, a company with $25 million is not small—it's minute! We suggest removal of the 2-percent limit because we do not believe it is needed and because it may, perversely, be regarded as a top limit in situations where fund managers would want to invest more in the smaller companies, and a larger amount would nevertheless be prudent.

I again want to thank the members of your two Committees for this opportunity to appear before you, and I shall be glad to respond to your questions.

EXHIBIT A

A recent study by the MIT Development Foundation campared the performance of six mature companies (Dupont, General Foods, International Paper, Proctor & Gamble, G.E. and Bethlehem Steel) with five innovative companies (IBM, Xerox, Polaroid, 3M and Texas Instruments) and with five young high-technology companies (Digital Equipment, Data General, National Semiconductor, Marion Labs and Compugraphics). From 1969 to 1974, the results were as follows:

[In percent]

	Sales growth	Job growth
Mature	11.4	0.6
Innovative	13.2	4.3
Young high technology	42.5	40.7

A study by the Commerce Technical Advisory Board showed that between 1945 and 1974, selected innovative companies such as Polaroid and Xerox grew at an average annual rate of 16.5% in sales and 10.8 percent in jobs. Over that period, selected mature companies such as Bethlehem Steel and General Foods grew at annual averages of only 7.8 percent in sales and 1.9 percent in new jobs. The Board noted that in the past six years, some high technology companies have far outrun either group.

EXHIBIT B

PRUDENT MAN REVISION, COULD CREATE JOBS

President-elect Jimmy Carter and most of his Democratic colleagues in Congress expressed great concern during the election campaign about the high level of unemployment in the United States.

Congress has tried to tackle the problem by passing bills designed to put the unemployment on the public payroll, but this is obviously an expensive, inefficient, short-term expedient.

A far better approach is to encourage the creation of jobs in the private sector. Many of those espousing this approach speak in terms of tax incentives to business to create new jobs for the hard-core unemployed.

But while giving money directly to the poor is acceptable, Congress usually balks at giving money to business to create meaningful jobs, so the tax incentive idea seems unlikely to get very far. That's a shame.

The Committee of Publicly Owned Companies (COPOC) has come up with a program which will help create jobs without costing the government, and hence the taxpayers, a cent.

COPOC wants Congress to define the "prudent man" investment standard in such a way that it does not actively discourage investment by pension funds in smaller companies. It is campaigning to have this definition made when Congress takes up revision of ERISA in 1977.

The committee argues that an unintentional effect of the ERISA investment standard has been to largely confine the investment of pension fund assets to blue chip securities.

Since these funds are a major source of equity capital, the committee argues, the result has been to deprive thousands of small and medium-sized companies of the investment capital they need to grow, prosper, produce goods and services and create jobs.

It says institutional investors have been "intimidated" by the prudent man standard, as stated in ERISA, or are taking refuge behind it, and increasingly limiting their investments to blue chip and fixed-income securities.

It points out that during the two years following the passage of ERISA, only 471 new issues of common stock were marketed compared with 888 new common stock issues in the two preceding years.

Further, 64 percent of pension trustees surveyed by the International Foundation of Employee Benefit Plans reported that as a result of ERISA they were less willing to invest in anything other than blue-chip type investments.

The committee has proposed that the stated objectives of ERISA should be amended to expressly declare a policy allowing pension funds to invest in a broad spectrum of American companies, and that the prudent man standard should be interpreted in that light.

It has also proposed that the prudent man rule be clarified to be expressly applicable to the total portfolio of pension plan investments rather than each individual investment.

And it has endorsed the Bentsen bill which proposes that pension fund managers should have leeway to invest up to 1 perecnt of the assets of any pension plan in companies with paid-in capital of less than $25 million.

These seem to be eminently sensible proposals. Pension funds should be invested in a broad spectrum of companies. Indeed, ERISA specifies diversification. Unfortunately, that has been offset by fear of fiduciary liability so that only 50 or 100 major stocks are favored.

The COPOC is not alone in calling for a wider, more modern interpretation of the prudent man rule in terms of the whole portfolio. James Hutchinson, former administrator of the Pension and Welfare Benefit Programs at the Labor Department, recently lent his voice to the call.

The Bentsen bill also seems to be a responsible proposal which may do some good without jeopardizing the integrity of pension funds. It could free up as much as $850 million for investment in smaller companies.

These modest and sensible proposals deserve consideration by the new administration and Congress, and active support by the pension industry.

Exhibit C

[From the Wall Street Journal, June 13, 1977]

Bank Sector Owns More of Glamour Shares in 1977 Than It Did at End of 1974, Study Finds

(By Charles J. Elia)

Ask any 100 market players what the really big investors have been doing for the past two years and 99 are likely to say the institutions have been dumping their growth stocks to diversify their portfolios.

There's some truth to that, of course. Investment interest has broadened since 1974 to include a wider range of stocks than in the growth-stocks heyday of 1972–73. And the weight, or value, of the earlier market favorites has definitely, been downgraded within many institutional portfolios.

But anyone who thinks this means that the biggest institutional sector—bank trust departments—has reduced its concentration of ownership of the old favorites has a surprise coming.

The bank sector as a whole—and that is where most pension funds are managed—today owns a larger percentage of the shares outstanding of Eastman Kodak, International Business Machines, Eli Lilly and a host of other sheel-shocked glamour stocks than it did at the end of 1974, with only a few noteworthy exceptions.

Individual banks, obviously, have restructured their portfolios, reducing glamour-stockholdings in the process. Morgan Guaranty Trust Co., of New York, for example, has sold millions of shares of more than a dozen growth stocks since 1974. But other banks, apparently, have been the buyers. For bank trusts as a group, the reduced portfolio weightings of the old favorites have come about more because of their sharp drops in price than because of wholesale dumping of portfolios.

Data are sketchy on most other institutions' transactions, but if any meaningful "distribution" of the old growth stocks was done by anyone, it seems to have been done by mutual funds. In almost every case, the mutual fund sector's percentage of ownership of shares outstanding has been reduced since 1974.

The accompanying table shows how the percentage ownership of a group of the banks' largest holdings of growth stocks changed between the end of 1974 and March 31, 1977, and what happened in the same period to holdings of those stocks among mutual funds. The data were compiled from Spectrum, a publication of Computer Directions Advisors, Silver Spring, Md. It covers about 170 bank trust departments reporting to the Comptroller of the Currency and nearly all mutual fund portfolios.

[In percent]

	Bank owned		Fund owned	
	Dec. 31, 1974	Mar. 31, 1977	Dec. 31, 1974	Mar. 31, 1977
IBM	21.5	22.5	5.1	4.5
Kodak	17.4	20.7	4.5	3.2
American Home Products	25.5	28.8	3.3	2.0
Merck	26.3	26.0	4.3	4.0
Lilly	26.3	29.9	3.3	1.9
Procter & Gamble	17.3	21.6	1.6	1.3
Sears Roebuck	15.0	15.8	1.3	1.6
Xerox	25.7	24.4	6.9	5.5
Schering-Plough	29.7	33.5	2.8	2.3
Kresge	29.8	34.5	8.0	6.9
Coca-Cola	19.3	20.8	2.0	2.1
Avon Products	23.7	22.9	7.5	7.1
McDonald's	26.2	24.3	16.3	8.0
Digital Eq	25.6	33.7	19.1	15.7

Misconceptions of another sort lie in wait for market students who jump to conclusions about mutual fund sales and redemption activity. Fund trends are followed by some for signs of when the funds might again become net buyers of stock.

On the surface, the sales-redemption picture looks much improved. The Investment Company Institute's monthly reports show conventional mutual funds' sales of their own shares to investors exceeded redemptions in two of the first four months of this year. From January through April, ICI data show, sales exceeded redemptions by $76 million.

But anyone who thinks this means a great turnaround for equity-oriented mutual funds would be mistaken. The totals for the first four months include a relatively new product—municipal bond funds. These funds, which don't have anything to do with stocks, have racked up net sales of more than $560 million in the first four months, and they're included in the ICI totals.

When the municipal bond funds are removed from the totals, mutual fund net redemptions in the first four months come to nearly $582 million. That's a better showing then the $1 billion of net redemptions a year earlier, but still represents considerable pressure on portfolio managers to raise money for investors who want to cash in.

In fact, mutual funds have been heavy net sellers of portfolio stocks, cutting back portfolio holdings nearly $1.8 billion in the first four months. In the like months last year, fund managers were net sellers of $389 million of equities. In all 1976, they sold $2.6 billion more stock than they bought.

Exhibit D

Selected Observations on the ERISA Prudent Man Rule

1. American Bankers Association

"We recognize that many investment managers have misconstrued the prudent man rule of ERISA and have become more conservative . . . It might be very helpful if Congress were able in some way to restate its intent."—Testimony, Bentsen Subcommittee, May 25, 1977.

2. SEC Chairman Harold Williams

"ERISA's standards of fiduciary responsibility have spawned a defensiveness among pension fund managers that is having a major reallocation effect. By and large, the losers are small, thinly capitalized issuers. I think what's happening here is that as a result of trying to remedy a situation where inappropriate investments were made, or really maybe careless investments were made, we may be at a point where the fiduciary consequence of taking what appears at the time to be a reasonable risk and ending up being wrong is too high. . . . A responsible fiduciary may have to behave more conservatively than good judgment would necessarily dictate, because if you're wrong, the consequences may be too high, in terms of potential liability."—Interview, *Securities Week*, May 23, 1977.

3. SENATOR LLOYD BENTSEN

"It is essential that Congress define the prudent man investment standard in such a way that it does not actively discourage investments by pension funds in smaller companies. The unintended effect of the prudent man rule has been to artificially confine the investment of pension fund assets to blue-chip securities. Since pension funds are a major source of equity capital, the result has been to deprive many smaller and medium-sized companies of the investment capital they need to prosper and grow."—Congressional Record, January 18, 1977.

4. SENATOR JACOB K. JAVITS

"If trade developments have shown any pattern, they have shown us that innovation is quickly transferred abroad and soon becomes the subject to intense competition; thus, domestic industry must continually be fed by new ideas that we must continue to develop . . . [Yet] . . . small, innovative firms, which are the backbone of technological development and greater productivity find themselves starved for capital and confronting hostile markets which simply do not permit them to expand or innovate further."—Javits Speech, May 2, 1977.

Senator BENTSEN. Why do we not let Mr. Krug proceed with his testimony?

STATEMENT OF MAURICE KRUG, CHAIRMAN, TECHNOLOGY, INC.

Mr. KRUG. Mr. Chairman, I am chief executive officer of Technology Inc., Dayton, Ohio. We have operations in Ohio, Michigan and Texas with sales offices at various other locations.

I believe that I represent a significant number of relatively young companies whose growth has been seriously retarded due to the unavailability of needed expansion capital. Therefore, I believe that I can best describe the plight endured by such companies by describing what has happened to our company.

For your information, Technology Inc. is a diversified company engaged in instrumentation, custom metal fabrication, and technical services with sales to industry and Government. Our present net worth is $5 million. Our company has revenues of approximately $20 million a year and employs 519.

It was started by me in January of 1960. I had $2,500 in cash, borrowed another $1,000 and a few other individuals put up the remaining money to give us the grand total of $5,000 to begin business.

We worked hard, some days working around the clock. It was a long time before I was able to draw a full salary and even longer until I earned the salary I was receiving from the University Research Center where I had previously been employed.

But I had faith in the country, as I do now, and with the innocence and ignorance that comes from being 30 years old and having little business experience, and a lot of good luck, we grew and prospered. In 1965, we took the company public raising a little over $1 million in capital that was promptly reinvested into the company which created more jobs and paid more taxes to the U.S. Treasury. By 1968, we had 2,500 shareholders—at least one in every State of the Union. The stock, which had originally traded at an adjusted price of about $5.30 per share rose to over $23 per share.

During this time, the company was engaged in a series of high technology development projects that looked extremely promising and we made a few acquisitions, but at that time, if you will recall, the stock market broke sharply and the ensuing credit crunch forced us to drastically revise our plans.

For us, that market—that equity market—never came back. We did retain some institutional investors who originally expected that things would get better. In the meantime, with only bank credit to rely on, the company was forced to sell off or dispose of existing operations that required additional capital to bring them to fruition.

For example, we discontinued investing in a subsidiary that converted chicken and livestock wastes into edible animal food. We sold the assets of the FR Corp., a manufacturer of specialty photographic chemical products, formerly of New York.

We merged the Lundell operation, a manufacturer of utility power plant alarm systems, formerly of Chicago, into an existing division and are now considering its sale or discontinuance. Just recently, we sold part of the business and liquidated the remaining assets of our HF photo systems division in Los Angeles, formerly known as the Houston Fearless Corp.

Although small, it was one of the leading manufacturers of photographic film processing equipment and related systems in the United States. There is no doubt in my mind that the employment of Technology Inc. could be an additional 1,500 or more employees had funds been available.

Certainly, the mood of the country being antibusiness at the time was harmful to industry, but especially to those of us who are small to medium sized. Additionally, the change in the capital gains tax laws further reduced the desire by an individual to risk his money in a smaller enterprise. The tax preference law and other laws and regulations unfavorable to business have made it extremely difficult for capital formation, the creation of new jobs and just doing business generally.

However bad all these things have been on small and medium-sized companies, the prudent man rule of ERISA may well be the last straw for us as far as capital formation is concerned. Briefly, and before I deal with the ERISA prudent man rule, the reason Congress adopted ERISA was because of the enormous and ever-expanding role that retirement and other employee benefit plans play in the life of our country. They have vast social as well as economic impact. And these plans involve staggering amounts of money—presently approaching $500 billion—making them clearly the most influential of investors. Thus, the importance of their role in the capital markets is obvious.

Before the advent of the prudent man rule, our company was being followed by some institutions, and we still had one or two who owned our stock. Since then, I can think of no instance where a fund or a broker seeking to place securities with an institution has even asked for information concerning our company.

Not long ago, and after ERISA, our last institutional holder, Value Line, sold their holdings. I believe it had nothing to do with the performance of the company which is reasonably good. The fact is, our company, in spite of having made substantial disposals of assets, is still about the same size as before.

In other word, our internal growth has approximately offset the dispositions of those businesses I referred to earlier. This, in spite of the fact that the rules of the game were changed in the middle of the game. And the rules are continually being changed to discourage equity investment.

The result is that companies like ourselves sell at 50 or 60 percent of book value and four or five times earnings, and are ripe for picking by the large corporations. I am sure that is just the opposite of what most of you gentlemen and the writers of previous bills had intended—that small businesses be gobbled up by the large ones and that funds not be available for those who wish to start an enterprise and to create jobs that did not exist before.

I sit on the board of a bank that has a little less than $400 million in assets. This bank manages pension funds for various companies and individuals. I have also talked with officers of large banks, and we now have what is known as the nifty 50—the 50 so-called best investments, and I might add, the largest companies for the most part, in this country.

These are the companies most sought after by pension fund managers. They are almost always in the Fortune first 500 list of companies, which start at sales of $327 million and on occasion will include some in the second 500 which goes down to about $100 million in sales.

The managers of pension funds have always been aware of their fiduciary responsibilities, but with the new ERISA prudent man rule, they are in general most reluctant to risk investing in any other companies. This is because they feel confident that their investment decisions will not be subject to later challenges since they were following the herd.

I hope you will agree with me that these people cannot afford to risk the penalties that could be imposed on them for what may prove, after the fact, to be an imprudent act. They are not about to invest someone else's money in a company such as ours even though we have a current ratio of almost 3 to 1 and a net worth of $5 million. We do not even begin to come close to meeting their criteria, and unless we can interest these money managers who control the investment of half a trillion dollars, our stock price and that of many similar companies will stay in the basement, and the equity market will be forever closed to us.

Now that I have told you my tale of woe, I would like to offer a suggestion or two as to how the rule could be modified in order to assist worthy companies, hopefully including ourselves, in raising needed capital. Senator Bentsen has proposed that the law be amended so that 2 percent of any fund could be invested in companies having a net worth of $25 million or less without violating the prudent man rule.

I think this type of action is certainly a most welcome move in the right direction and merits enthusiastic support. However, I would like to urge consideration of reducing the size of eligible companies from $25 million to $5 million or thereabouts, and specifically including start-up situations. My reason is simple.

If the breaking point is $25 million, I am concerned that the fund managers, in the exercise of the excess caution for which they are noted, will tend to ignore companies with net worths of less than, say, $15 or $20 million. If the breaking point is $5 million, it would, by implication, clearly bless investments in companies with net worths in excess of $5 million and still permit capital investment in small companies.

And I am not trying to relieve a fund manager of his fiduciary respsonsibilities, but to put in writing for all to see that investing in start-up situations or in small or medium sized companies in itself is not a bad thing and on the surface is not construed to be imprudent.

With respect to the portion of a pension fund which may be invested in small companies, I would personally prefer that there be no percentage limitation. However, recognizing that excesses could occur, I can understand why the committee may feel that such a limitation is essential, but I am of the opinion that the 2 percent limit should be increased.

In conclusion, the important thing is that some positive step be taken to amend this prudent man rule so that funds managers will not feel compelled—in order to avoid possible future liability—to hide behind the nifty 50, the Fortune 500, or whatever large companies are in vogue at any particular time.

Although it will take many positive moves on the part of Congress to facilitate capital formation, this is a very good start. I ask your committee for support.

I appreciate your attention. It has been a pleasure to be able to discuss my problem and the problem of many, many similar companies with you, and I would be pleased to answer any questions that you may have.

Thank you.

Senator BENTSEN. Thank you.

On your recommendation, somewhat similar to what Mr. Krug is talking about, talking about the entire portfolio being looked at rather than an individual stock on a prudent man application, that is what you are stating?

Mr. WOOD. Absolutely.

Senator BENTSEN. I think that that is a good suggestion. we will see what the rest of the committee members think.

Mr. WOOD. It is about the only way you can do it. You cannot do it just on an individual stock basis. Otherwise you can have bad luck and wind up in trouble.

If you look at is on an overall basis, then pension funds can help little companies. That is how big companies got here. They had to be little once to get started. That is what built our country people investing in little companies.

Senator BENTSEN. I note your testimony on that. You point out that only 658 new issues of common stock were marketed in 1974, 1975, and 1976 as compared to 2,922 issues in 1971, 1972, and 1973.

Corporate debt/equity ratios have doubled since 1970. If you try to expand, now you have to do it through debt instead of equity, or if you are taken over by some of the very large companies and all of the obligations that go with it.

Mr. WOOD. There is no way to raise equity money today, It is out of the question for small companies. We cannot afford to pay dividends. That hurts us. We have to keep the money, to keep growing.

We cannot pay stock dividends. That hurts us in the eyes of the pension funds, without any questions.

Senator BENTSEN. I note that some of the Nation's leading bankers state that the prudent man rule has discouraged investments in new and smaller firms. In response to a questionnaire, the vice president of the Chemical Bank told this committee—

A number of factors, including the enactment of ERISA have caused us to reduce substantially our investment of pension funds in venture capital situations. We had an executive of Wachovia Bank and Trust Co. who stated: Because of ERISA, we feel it is no longer appropriate to make venture capital investments in retirement funds.

That is the type of thing that we are running into, that dictates that we change the interpretation of the prudent man rule.

Gentlemen, unless you have something further to add, we are very appreciative of your presentation. Thank you very much.

We have the representatives of the Computer & Communications Industry Association, Mr. Alfred A. King, chairman, MRI Systems Corp., Austin, Tex.; Mr. John E. Jones, president, Cummins-Allison Corp., Glenview, Ill.; and Mr. A. G. W. Biddle, president, Computer & Communications Industry Association, Arlington, Va.

STATEMENT OF A. G. W. BIDDLE, PRESIDENT, COMPUTER & COMMUNICATIONS INDUSTRY ASSOCIATION, ARLINGTON, VA.

Mr. BIDDLE. If I might, I would like to lead off.

My name is Jack Biddle. I am president of the Computer & Communications Industry Association. As the chairman noted, I am accompanied by Mr. Alfred King, chairman of the board, MRI Systems, and Mr. John Jones, president of Cummins Allison, and Mr. John Chapman, our counsel.

The CCIA was formed 5 years ago next week and it represents 40 member companies with combined revenues in excess of $2 billion annually, employing more than 60,000 persons. The member firms range in size from under a million dollars in annual sales to over $300 million. Our members manufacture products which cover the full spectrum of goods and services associated with computers, data processing, and data communications.

I might note that in April of this year our association scheduled a major security analysts conference where it was our intention to bring together the chief executives and chief financial officers of many of our member companies on an intimate, get to know each other basis with a number of the leading securities analysts who monitor our industry.

Some 20 of our member companies signed up to participate in this conference and represented companies growing at 25 to 30 percent a year. A number of them had revenues in excess of 100 million. We invited some 1,200 securities analysts. Only 15 deemed these companies worthy of their time and attention.

When we polled the ones who did not sign up to participate in the conference, we found that the general response was that these companies were too small to bother with. They could not afford to invest in companies under $500 million in revenue so they would not be investing in them in any case, so why take time to become familiar with them?

This is one of the reasons we have come before this committee today.

The association, in working intimately with its member companies, is well aware that capital has become a scarce resource in the computer and communications industries. We are all aware of the phenomenal economic growth resulting from product innovations representing advances in computer and communications technology. It must be recognized that capital has been the sustenance for the growth of these industries, and the availability of capital or the lack thereof will affect the extent to which these vital industries will continue to develop.

Senator Bentsen, in introducing S. 285 in January of this year, noted that venture capital was essential in the development of the central computer industry and the minicomputer industry, including the concomitant benefits of more and better jobs, increased tax revenues, and improved industrial productivity.

External sources of working capital will be necessary for the continuing growth of these industries. For example, the capital requirements over the next 5 years for the minicomputer companies have been estimated to be $500 million and for the medium- and large-scale computer companies over $1 billion, excluding IBM's needs. In addition, an emerging new industry, the microcomputer or microprocessor industry, has been spawned from earlier risk investments in the semiconductor industry. This new industry requires $400 million in outside capital for sustained growth.

Projected capital shortages are not just unique to the industries which the CIAA directly represents. In general, business investment and external financing needs are expected to increase substantially over the next decade. While capital funding may be provided from internal cash flow, borrowings, and equity financing, the role of new equity capital is central to the formation of new businesses, to modernization and diversification within existing businesses, and to the provision of a healthy balance against borrowed capital.

In March of this year, it was reported that for the 10 years ended in 1975, total fund requirements of nonfinancial corporations for plant and equipment expenditures and other physical investment and acquisition of financial assets, averaged $108 billion a year. Capital generated internally provided 60 percent of the total sources of funds, while outside financing provided 40 percent. Debt financing was seen to be the predominant form of outside financing, with net additions to debt averaging $41 billion a year, or more than twice the $19 billion average increase in equity capital. Equity capital, on average per year, was derived from retained earnings of $13 billion and new equity financing of $6 billion.

Over the next 10 years, a more substantial level of investment is required to meet economic and social goals and legislated mandates regarding environmental and safety standards. Just to maintain the standard of living enjoyed in the United States, which has been perceived to be under attack by inflation and substantially higher energy costs, would require more investment funds in the future. It has been estimated that the American economy over the next 10 years needs an average of $274 billion in total investment a year for the maintenance of general economic growth.

Outside capital has always been necessary to meet investment needs. Over the past 10 years debt financing has been relied upon primarily to serve the outside capital requirements. In fact, the role of debt capital has become overly dominant in the investment equation. For manufacturing companies alone, liabilities rose from 64 percent of net worth at the end of 1965 to 86 percent at the end of 1975. For manufacturing companies with assets of less than $50 million, liabilities increased from 76 to 100 percent of net worth over the same period.

I did an informal survey of the recently published Forbes 500's. I was shocked, and sympathetic with the statements of the prior witness, to find among those 500, over a third of the companies have a net worth three or more times greater than the total market value of their outstanding stock. In a sense, this sets up some one-third of our largest companies for takeovers and can lead to further corporate concentration in our country.

Such reliance has placed a high demand on loan funds resulting in higher interest charges which in turn have led to a deterioration in retained earnings. This phenomenon has reduced the availability and significance of internal financing. Moreover, it is not certain that debt financing to the extent encountered in recent years may even be available for new investment needs. The forces of economic uncertainty and almost certain inflation in the years ahead have induced corporations to strive for long-term financing, while the same factors are causing banks and other institutions to prefer placing funds on a short-term basis.

In any case, any undue reliance by business on debt financing leads to an increase in bankruptcies and at the very least, instability in industrial strength. A reduced emphasis on debt as a source of capital is desirable, and will require a corresponding increase in external equity financing if overall investment needs are to be met.

I am not here today to advocate a program for forming the necessary capital to meet these investment needs. Such a program, however, is desperately needed. I am here today endorsing S. 285 and providing testimony in support thereof because the CCIA is concerned that the existing distribution of investment funds is inequitable and imprudent.

The result has been an extraordinary commitment by pension funds to a handful of securities of the giants of American industry, which have been euphemistically referred to as the "Nifty Fifty." The structure of the American capital markets is inherently unstable with such substantial capital resources hanging on a single tier of the economy.

The illiquidity of the situation has been manifest often by the parallel rush in and out of certain of these securities upon the negative or positive poles of short-term news.

The precipitous price changes in the short-term valuation of such securities has frightened away the private investor who was traditionally relied upon to add liquidity to the stock market, provide risk capital for new ventures, and fund secondary investment markets which permitted many companies in the past to "go public."

If the giants of the industry always outperform the rest, then perhaps the parallel investment decisions by the pension funds could be justified. This is simply not the case. The "Nifty Fifty" stocks have not always outperformed the market averages. Consider, too, that any one of the "Nifty Fifty" stocks had a significantly better return on investment during its younger growth years than it does today.

Not only would a diversification of investment funds by portfolio managers be sound economically, but the fiduciary responsibilities that the managers have with respect to pensioners and beneficiaries mandate that these improved yields be attained through diversification of investment funds into small and medium-sized businesses which may realize more substantial growth than that of the mature giant corporations.

We may realize that the present conduct of the portfolio manager is defensive in nature, but it is certainly not defensible conduct in view of the pensioner's entitlement to the best yields he or she can get from the service of a more diversified portfolio.

In enacting ERISA, the Congress evidenced its intention to significantly broaden portfolio investment beyond the "Nifty Fifty." ERISA was intended to allow a flexibility in the selection of investments not found in personal trust law. In connection with one of the very first bills introduced in 1970, H.R. 16462, which contained essentially the same prudent man rule language of present law. Secretary of Labor George Schultz testified:

> The Administration rejected the old, common law prudent man rule because it was too inflexible and did not recognize the differences that exist among the plans of different size and nature.

Similarly, the American Bankers Association supported the 1970 language, stating:

> Reformation of the common law prudent man rule was intended to eliminate the straitjacket on investments that the common law prudent man rule has imposed in the field of personal trusts.

Finally, the conference committee report on ERISA stated:

> The conferees expect that the courts will interpret the prudent man rule—and the other fiduciary standards—bearing in mind the special nature and purpose of employee benefit plans.

S. 285 is a much needed first step toward a reform of the too conservative investment standard of the pension funds. Section 2, in requiring a 5-percent limit with respect to any class of a corporate security which meets the statute, puts pressure on the portfolio manager to distribute a fund's assets over a greater number of investments.

Hopefully, section 3 will remove an excuse which some managers have made against investing in small and medium-sized companies. Pension-fund managers have argued from the enactment of ERISA that fiduciary standards imposed by the prudent man rule have prevented them from placing investments in other than large blue-chip and fixed-income securities. Moreover, attorneys advising trust officers have interpreted ERISA regulations too conservatively.

Clearly this is not what Congress intended under ERISA. Nonetheless, until Congress' intention is clarified through legislation or the ERISA rulemaking process, the plain fact is that investments will not be made in small companies or in venture capital situations.

The association would like to suggest that section 3 could be broadened to insure that pension funds may flow to a broad spectrum of

American companies. First, we would like to see a full 5-percent basket of trust funds to be permitted for investments in small to medium-sized corporations. We feel that they should have a capital account of less than $100 million.

There is a growing realization that the capital formation process is a continuum. You must create a secondary market to create new issue markets.

Second, we would like to suggest the additional wording contained on page 10 of our prepared statement relative to revision of the prudent man rule.

I would like at this time for Alfred King to address the committee.

Senator BENTSEN. We have been friends for most of our lifetime, and I am delighted to have him here to testify.

STATEMENT OF ALFRED A. KING, CHAIRMAN, MRI SYSTEMS CORP., AUSTIN, TEX.

Mr. KING. Mr. Chairman, I am Alfred King, chairman of the board of MRI Systems Corp., in Austin, Tex. MRI Systems is a small, but rapidly growing computer software firm. We have designed, developed, and marketed a large and sophisticated data base management program that makes it possible to organize and manage huge computer files of information. I appear before you today as a concerned citizen and business executive in support of the Pension Investment Act of 1977, identified as S. 285. My understanding is that this bill is designed to protect private pension plan participants from the capital losses which might occur as a result of the current trend toward excessive concentration of pension investments in the stocks of a very few large companies.

I am aware that private pension assets are under the control of a small number of financial institutions that concentrate their investments in a select group of stocks which represent only a narrow segment of the broad spectrum of companies which contribute to the economy and to the general welfare of the United States. I believe that those who have proposed this act have correctly assessed that the continuance of this situation presents a danger to the welfare of pensioners and to the Nation as a whole.

As a businessman, I am aware of the transformation in the character of the capital markets upon which American businesses depend to finance their current activities and future growth. Until the late 1960's or early 1970's, qualified business organizations were able to obtain financing in a mix of debt and equity which provided stability both for the organization and the economy. Because a businessman had the alternative of turning to equity markets for financing, the cost of borrowed capital was maintained at reasonable interest charges.

Over this last decade, however, we have seen a growth in various institutions, such as mutual and pension funds, which have come to dominate trading in the securities markets. Because of the impact on these markets of fewer and fewer people trading larger and larger blocks of the stock of the same huge corporations, the large numbers of small investors who formerly gave diversity and body to the stock market are apparently withdrawing in confusion from equities and are committing their investable funds elsewhere.

The growth of these large funds with their increased control over the Nation's capital markets, combined with restrictive security regulations and increasing taxation of capital gains, has caused capital to cease flowing to the small and medium-sized businesses which most need this capital to finance future growth. One of the causes of this cessation is addressed by this proposed legislation—that is, that in the main, the institutions which control the allocation of capital in this country do not invest in anything but the very large, heavily capitalized companies which dominate their particular industries.

Thus, the present situation, as I perceive it, is a frightening one. Small- and medium-sized businesses have been stalled and shut off from funds badly needed for productive growth and are not able to contribute their full share of vigor to the American economy. After all, the activities of small- and medium-sized businesses account for a majority share of the gross national product. Small businesses alone comprise 97 percent of all businesses, unincorporated and incorporated, in the United States. More than half of all business receipts are generated by their operations. Perhaps more important, these small businesses employ more than half the U.S. business work force.

The Nation, then, must strongly encourage a wider distribution of control over the vast capital resources of this country; and we must do all in our power to permit and encourage much wider diversification in the investment of these critical resources. We cannot permit so basic a natural resource to be used primarily for the benefit of giant corporations to the detriment of the smaller corporations which have been the key components of America's economic successes to date.

I do not need to point out that over a period of 20 years the Haloid Corp., a small producer of photographic products, turned the concept of xerography into the substantial reproduction industry of today. At the time that Haloid, now the Xerox Corp., committed itself to that growth industry, IBM and Kodak did not see the merit in pursuing the potential of this new technology.

I do not believe that we can expect mature and dominant corporations, who today are siphoning off the bulk of investment capital, to originate and follow through on new technologies in the same way that small- and medium-sized businesses function in a free economy. These large corporations have large sums invested in the technology they are currently exploiting, and are generally committed to programs of gradual linear progress rather than to the exciting new technology and quantum jumps in existing technology that are vital to the profitability and sometimes to the existence of smaller corporations and individual entrepreneurs.

Senator BENTSEN. What I feared most has come to pass. We have a roll call on the floor of the Senate.

Could you summarize your statement?

Mr. KING. Fortunately, I believe the entrepreneurs are still around and if the funds were available, they would be ready to use them in a way that would benefit the economy of the United States.

I have a couple of suggestions that are in my prepared statement about the bill itself and a suggested tax modification that might help unblock funds. I think that there are a number of causes which are contributing to the drying up of funds to smaller businesses. The problem addressed by this act is one: In my own case, I have taken considerable risk and have played a major part in the financing of MRI Systems Corp. and its product which I believe to be of some small importance to this country. At least, it has provided employment for more than 190 people. In any event, I would not attempt to start such an enterprise in todays tax and investment climate.

We must work together to restore the proper economic environment in this country, one which will foster continued growth and new growth industries. If we are to solve our employment and social problems, we have no other responsible choice. I believe S. 285 is a step in the right direction.

Senator BENTSEN. Thank you.

Mr. King, let me comment for just a minute. There are two philosophies, I guess, in this country. One is that you ought to have something for the free enterprise out there to compete for, and I think you do that through the tax system, to achieve some objectives of the country, energy, housing, whatever it might be; and I think that is the most effective and most effiicent way.

The other way is to say, well, it is a subsidy, label it as such, and hand it all out by the government. I think that is a very inffective way of doing it.

In this country, we have always had risk takers and we have had caretakers. Unless you have some incentives for the risk takers, you are not going to have anything left for caretakers. That means you have to have some reward for the fellow who succeeds.

When I hear about the Xerox Corp. I am also reminded of the fellow who wins the daily double at the racetrack. You read about them. All you have to do is go out there and look at that race track and see all those torn-up ticket stubs on the pavement of the people who do not collect.

That is what happens. New companies starting, a vast majority of them never succeed, but there are a few who do, if the incentives are there, and if they pay the price and take the risks and get to keep some of it.

I have seen a limitation put on interest deductions in our tax laws that I have opposed. That was originally put on because of the capital gains situation where they talk about they hold something with low return and borrow the money to build and convert it to capital gains.

Now your capital gains go up to as much as 49.2 percent. They forget that when they continue to put limitations on the deductions for interest. Whatever I build, I build on OPM—other people's money, borrowed money. That is what it is with the venture capitalists in this country.

If the young fellow starting out, taking the risk, boot strapping his way up. That kind of thing the tax law does not bother. The weathy man, who has a lot of investment income.

But you have a real move in this country to punish savings and earnings from savings and investment in that situation.

Mr. Jones, why do you not make your comments. When they ring those bells, I have to go out the door.

STATEMENT OF JOHN E. JONES, PRESIDENT, CUMMINS-ALLISON CORP., GLENVIEW, ILL.

Mr. JONES. I am here to verify that it is difficult to get equity capital today. The importance to a small company of the availability to it, because if you come to the point where you have a product that has great potential, you have got to penetrate the market sufficiently so you are not pushed out of it, and you cannot just grow at a 10 or 15 percent rate. You have to grow at a faster rate. That requires equity to match up against the debt to make that safe.

Senator BENTSEN. Thank you very much, gentlemen, for your testimony. I apologize for the limitation upon your time.

Thank you for coming. We will have your full statements in the record, and we will be working to try to assist you.

Mr. BIDDLE. Senator Bentsen, if it has not already been done, I would urge the committee to consider including the Casey Commission study as a part of the record of these hearings. It certainly shows that the ERISA problem is one part of the total capital formation problem, something perhaps your colleagues do not fully appreciate.

Senator BENTSEN. We will see how extensive that is, and if we can——

Mr. KING. The SBA Task Force on Venture and Equity Capital.

Senator BENTSEN. We will put it in. Thank you very much.

[The prepared statements of Messrs. Biddle, King and Jones and the report of the SBA Task Force follow:]

STATEMENT OF A. G. W. BIDDLE, PRESIDENT, COMPUTER AND COMMUNICATIONS INDUSTRY ASSOCIATION

Mr. Chairman and members of the Committees, my name is Jack Biddle, and I appear before you today as president of the Computer & Communications Industry Association, a trade association referred to as the CCIA. The CCIA, formed over 4 years ago, represents today approximately 40 member companies with combined revenues in excess of $2 billion annually and employing more than 60,000 persons. The member firms range in size from under $1 million in annual sales to over $300 million. Our members manufacture products which cover the full spectrum of goods and services associated with computers, data processing, and communications.

The CCIA in working intimately with its member companies is well aware that capital has become a scarce resource in the computer and communications industries. We are all aware of the phenomenal economic growth resulting from product innovations representing advances in computer and communications technology. It must be recognized that capital has been the sustenance for the growth of these industries, and the availability of capital or the lack thereof will affect the extent to which these vital industries will continue to develop.

Senator Bentsen, in introducing S. 285 in January of this year, noted that venture capital was essential in the development of the central computer industry and the minicomputer industry, including the concomitant benefits of more and better jobs, increased tax revenues, and improved industrial productivity.

External sources of working capital will be necessary for the continuing growth of these industries. For example, the capital requirements over the next 5 years for the minicomputer companies have been estimated to be $500 million and for central computer companies over $1 billion, excluding IBM's needs. In addition, an emerging new industry, the microcomputer or microprocessor industry, has been spawned from earlier risk investments in the semiconductor industry. This new industry requires $400 million in outside capital for sustained growth.

Projected capital shortages are not just unique to the industries which the CCIA directly represents. In general, business investment and external financing needs are expected to increase substantially over the next decade. While capital funding may be provided from internal cash flow, borrowings, and equity financing, the role of new equity capital is central to the formation of new businesses, to modernization and diversification within existing businesses, and to the provision of a healthy balance against borrowed capital.

In March of this year, it was reported[1] that for the 10 years ended in 1975, total fund requirements of non-financial corporations (for plant and equipment expenditures, other physical investment and acquisition of financial assets) averaged $108 billion a year. Capital generated internally provided 60 percent of the total sources of funds, while outside financing provided 40 percent. Debt financing was seen to be the predominant form of outside financing, with net additions to debt averaging $41 billion a year, or more than twice the $19 billion average increase in equity capital. Equity capital, on average per year, was derived from retained earnings of $13 billion and new equity financing of $6 billion.

Over the next 10 years, a more substantial level of investments is required to meet economic and social goals and legislated mandates regarding environmental and safety standards. Just to maintain the standard of living enjoyed in the United States, which has been perceived to be under attack by inflation and substantially higher energy costs, would require more investment funds in the future. It has been estimated that the American economy over the next 10 years needs an average of $274 billion in total investment a year for the maintenance of general economic growth.

Outside capital has always been necessary to meet investment needs. Over the past ten years debt financing has been relied upon primarily to serve the outside capital requirements. In fact, the role of debt capital has become overly dominant in the investment equation. For manufacturing companies alone, liabilities rose from 64 percent of net worth at the end of 1965 to 86 percent at the end of 1975. For manufacturing companies with assets of less than 50 million, liabilities increased from 76 to 100 percent of net worth over the same period.

Such reliance has placed a high demand on loan funds resulting in higher interest charges which in turn have led to a deterioration in retained earnings. This phenomenon has reduced the availability and significance of internal financing. Moreover, it is not certain that debt financing to the extent encountered in recent years may even be available for new investment needs. The forces of economic uncertainty and almost certain inflation in the years ahead have induced corporations to strive for long-term financing, while the same factors are causing banks and other institutions to prefer placing funds on a short-term basis.

In any case, any undue reliance by business on debt financing leads to an increase in bankruptcies and at the very least instability in industrial strength. A reduced emphasis on debt as a source of capital is desirable, and will require a corresponding increase in external equity financing if over-all investment needs are to be met.

I am not here today to advocate a program for forming the necessary capital in meeting such investment needs. I am here today endorsing S. 285 and providing testimony in support thereof because the CCIA is concerned that the existing distribution of investment funds is inequitable and imprudent.

The investment community has become institutionalized to the extent that institutions now account for 70 percent of the volume of trading on the New York Stock Exchange. Assets which provide the necessary resources for investment have become increasingly concentrated in the hands of the few, with access to them more difficult particularly for small- and medium-sized businesses. Since 1962, deposits in the ten largest banks have increased from 20 percent to 33 percent of all deposits. Mutual fund assets have doubled in the same time period. Pension fund assets have tripled, and it is estimated that by 1985 more than half of all external equity capital will be in the hands of pension-fund managers.

Have pension-fund managers met their fiduciary responsibilities in managing the more than $200 billion of private pension assets under their control? The answer is an emphatic NO. It is becoming increasingly clear that pension-fund managers in general have made primarily defensive investments in pursuit of their personal interests, such as convenience and job security. It is considered

[1] Walter S. McConnell and Steven D. Leit, "Inflation, Stock Prices and Job Creation," *Financial Analysts Journal*, March–April 1977, page 27.

safe for the fund manager to invest the assets under his control in the same securities accepted by his colleagues. The portfolio manager who may be tempted to venture out from the accepted investments to seek higher yields may even be prevented from doing so by policy considerations established by his supervisors, who may themselves be motivated to secure a track record based on conventional action which cannot later be criticized.

The result has been an extraordinary commitment by pension funds to a handful of securities of the giants of American industry, which have been euphemistically referred to as the "Nifty Fifty." The structure of the American capital markets is inherently unstable with such substantial capital resources hanging on a single tier of the economy. The illiquidity of the situation has been manifest often by the parallel rush in and out of certain of these securities upon the negative or positive poles of short term news.

The precipitous price changes in the short term valuation of such securities has frightened away the private investor, who was traditionally relied upon to add liquidity to the stock market, provide risk capital for new ventures, and fund secondary investment markets which permitted many companies in the past to "go public."

If the giants of the industry always outperform the rest, then perhaps the parallel investment decisions by the pension funds could be justified. This is simply not the case. The "Nifty Fifty" stocks have not always outperformed the market averages. Consider too that any one of the "Nifty Fifty" stocks had a significantly better return on investment during its younger growth years.

I would like to provide you with an example, which I find interesting, of how this failure of responsibility to diversify investments on the part of a portfolio manager is tantamount to imprudent conduct. Some years ago, First National Bank of Chicago bought an investment portfolio from Booth Computer which became known as "Bay Equities," which represented investments in small- and medium-sized companies in the San Francisco Bay area. Over the past five years the Bank recognized a rate of return of some 12 percent from its venture capital portfolio against a mere 1 percent return on other investments. In view of this case, inprudence would be staying with the so-called safe investment to the exclusion of investments with greater potential.

Not only would a diversification of investment funds by portfolio managers be sound economically, but the fiduciary responsibilities that the managers have with respect to pensioners and beneficiaries mandate that these improved yields be attained through diversification of investment funds into small- and medium-sized businesses which may realize more substantial growth than that of the mature giant corporation. We may realize that the present conduct of the portfolio manager is defensive in nature, but it is certainly not defensible conduct in view of the pensioner's entitlement to the best yields he or she can get from the service of a more diversified portfolio.

In enacting ERISA, the Congress evidenced its intention to significantly broaden portfolio investment beyond the "Nifty-Fifty." ERISA was intended to allow a flexibility in the selection of investments not found in personal trust law. In connection with one of the very first bills introduced in 1970 (H.R. 16462), which contained essentially the same "prudent man" rule language of present law, Secretary of Labor George Shultz testified:

"The Administration rejected the old (common law prudent man) rule . . . because it was too inflexible and did not recognize the differences that exist among the plans of different size and nature."

Similarly, the American Bankers Association supported the 1970 language, stating:

"Reformation of the common law prudent man rule was intended to eliminate the straitjacket on investments that the common law prudent man rule has imposed in the field of personal trusts."

Finally the Conference Committee Report on ERISA stated:

"The conferees expect that the courts will interpret the prudent man rule (and the other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans."

S. 285 is a much needed first step towards a reform of the too conservative investment standards of the pension funds. Section 2, in requiring a 5 percent limit with respect to any class of a corporate security which meets the statute, puts pressure on the portfolio manager to distribute a fund's assets over a greater number of investments. Hopefully, Section 3 will remove an excuse which some managers have made against investing in small- and medium- sized companies. Pension-fund managers have argued from the enactment of ERISA that fiduciary standards imposed by the prudent-man rule have prevented them from placing investments in other than large blue-chip and fixed-income securities. Moreover, attorneys advising trust officers have interpreted ERISA regulations too conservatively.

One major problem seems to be the applicability of the 1974 decision of the New York Court of Appeals in *Bank of New York* v. *Spitzer*, 85 N.Y. 2d 512 (1974) to the prudent man rule of ERISA. In that case, the highest court of the State of New York held that the fact that a trust portfolio shows a substantial overall increase in value during an accounting period does not insulate the trustee from responsibility for imprudence or negligence with respect to a particular investment. While at first blush it may seem appropriate to impose liability for negligence and/or imprudence, the thrust of the decision is that the appropriateness of a particular investment is to be measured in a vacuum—totally without regard to the overall portfolio investment strategy, diversity, risk and results. In other words, negligence and/or imprudence may not be measured by the courts, as they should be, within the context of the total portfolio.

Clearly, this is not what Congress intended under ERISA. Nonetheless, unless and until Congress' intention is clarified through legislation or through the ERISA rule-making process, the plain fact is that investments will not be made in small companies or in venture capital situations. Such an amendment or rule would complement the approach taken in S. 285 and would facilitate such investments even within the 2 percent rule. Certainly, it is a prerequisite to encourage such investments beyond the 2 percent proposal of the Bill. What we are witnessing today was predicted in 1975 by Martin Lipton, adjunct professor of law at New York University:

"While this language would appear to protect the well researched, well considered venture capital investment, the *Spitzer* case will still deter many trustees and investment managers from all but the commonly accepted "sound" investments. In addition to dryingup venture capital, this could exacerbate the two-tier market problem for equities and, along with the actuarial disadvantages to equity investment built into the Pension Reform Act of 1974, could result in a long-term fundamental shift by institutional investors from equities to debt."

We believe that S. 285 will redirect the flow of investment funds to provide some degree of investment in medium- and small-size companies which otherwise would not take place. This process, we believe, will result in enhanced portfolio yields for the pension funds to provide increased benefits to pensioners and beneficiaries. You have already heard testimony in May from Karen Ferguson, Director of the Pension Rights Center, who stated that, for every 1 percent increase in returns on a trust portfolio, a pension can pay out between 10 percent and 20 percent more in benefits. The process serves the American economy as a whole by the additional benefit of a more uniform distribution of capital funds across the economic sectors of the nation, with badly needed capital flowing to small and medium corporations. Thus, the ultimate benefits of S. 285 is the nourishment of the critical growth sectors of the American economy.

The CCIA would at this time like to provide specific recommendations on how Section 3 could be broadened to ensure that pension funds may flow to a broad spectrum of American companies. First of all, we would like to see a full 5-percent "basket" of trust funds to be permitted for investments in small- to medium-sized corporations having a capital account less than *$100,000 million* or any investment company which invests primarily in such securities. It ought to be recognized by all that the 2 percent leeway provision of S. 285 does not set aside "mad money" for imprudent investments. Rather, this leeway clause merely removes a technical obstacle not intended by the enactment of ERISA which has given cause to portfolio managers to trade exclusively in the large, blue-chip corporation with their mature standing and massive capital accounts.

We also propose that language be included within Section 3 to clarify that the prudent man standard of ERISA is applicable not to individual investments on an isolated basis, but to such investment within the context of the total portfolio of pension fund investments. For example, under Section 1104 of ERISA, the fiduciary duties set forth therein under subparagraphs (a)(1)(C) could be clarified as follows:

". . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—. . . (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances *and considering the portfolio of diversified investments as a whole* it is clearly prudent not to do so; . . ." (Added text is emphasized.)

Such a statutory or rule-making clarification of the prudent man standard would resolve the unsettled question as to whether a fund manager is held to a minimum risk analysis with respect to each and every investment or he may take prudent investment risks which business theory teaches us should be part of every sound investment portfolio.

Statement of Alfred A. King

Good morning, Mr. Chairman, members of the Committees. I am Alfred A. King, Chairman of the Board of MRI Systems Corporation in Austin, Texas. MRI Systems is a small, but rapidly growing computer software firm. We have designed, developed, and marketed a large and sophisticated data base management program that makes it possible to organize and manage huge computer files of information. I appear before you today as a concerned citizen and business executive in support of the Pension Investment Act of 1977, identified as S. 285. My understanding is that this Bill is designed to protect private pension plan participants from the capital losses which might occur as a result of the current trend toward excessive concentration of pension investments in the stocks of a few very large companies.

I am aware that private pension assets are under the control of a small number of financial institutions that concentrate their investments in a select group of stocks which represent only a narrow segment of the broad spectrum of companies which contribute to the economy and to the general welfare of the United States. I believe that those who have proposed this Act have correctly assessed that the continuance of this situation presents a danger to the welfare of pensioners and to the nation as a whole.

As a businessman, I am aware of the tranformation in the character of the capital markets upon which American businesses depend to finance their current activities and future growth. Until the late 1960's or early 1970's, qualified business organizations were able to obtain financing in a mix of debt and equity which provided stability both for the organization and the economy. Because a businessman had the alternative of turning to equity markets for financing, the cost of borrowed capital was maintained at reasonable interest charges.

Over this last decade, however, we've seen a growth in various institutions, such as mutual and pension funds, which have come to dominate trading in the securities markets. Because of the impact on these markets of fewer and fewer people trading larger and larger blocks of the stock of the same huge corporations, the large numbers of small investors who formerly gave diversity and body to the stock market are apparently withdrawing in confusion from equities and are committing their investable funds elsewhere.

The growth of these large funds with their increased control over the nation's capital markets, combined with restrictive security regulations and increasing taxation of capital gains, has caused capital to cease flowing to the small- and medium-sized businesses which most need this capital to finance future growth. One of the causes of this cessation is addressed by this proposed legislation—that is, that in the main, the institutions which control the allocation of capital in this country do not invest in anything but the very large, heavily-capitalized companies which dominate their particular industries.

Thus, the present situation, as I perceive it, is a frightening one. Small- and medium-sized businesses having been stalled and shut off from funds badly needed for productive growth are not able to contribute their full share of vigor to the American economy. After all, the activities of small and medium-sized businesses account for a majority share of the gross national product. Small businesses alone comprise 97 percent of all businesses, unincorporated and incorporated, in the United States. More than half of all business receipts are generated by their operations. Perhaps more important, these small businesses employ more than half of the U.S. business work force.

This nation, then, must strongly encourage a wider distribution of control over the vast capital resources of this country; and we must do all in our power to permit and encourage much wider diversification in the investment of these critical resources. We cannot permit so basic a natural resource to be used primarily for the benefit of giant corporations to the detriment of the smaller corporations which have been the key components of America's economic successes to date.

I do not need to point out that over a period of twenty years the Haloid Corporation, a small producer of photographic products, turned the concept of xerography into the substantial reproduction industry of today. At the time that Haloid, now the Xerox Corporation, committed itself to that growth industry, IBM and Kodak did not see the merit in pursuing the potential of this new technology. I do not believe that we can expect mature and dominant corporations, who today are siphoning off the bulk of investment capital, to originate and follow through on new technologies in the same way that small- and medium-sized businesses function in a free economy. These large corporations have large sums invested in the technology they are currently exploiting, and are generally committed to programs of gradual linear progress rather than to the exciting new technology and quantum jumps in existing technology that are vital to the profitability and sometimes to the existence of smaller corporations and individual entrepreneurs.

I am sure that fund managers have a myriad of defenses to the close relationship that exists between them and very large corporations. None of them, however, can be persuasive against the very real threat to the economic viability of the United States and to our free enterprise economic system.

Fortunately, America has not lost its entrepreneurs. These entrepreneurs are there awaiting funds to put to work toward the generation of new techniques and technologies for the modernization of our existing industries and the creation of new ones.

For many reasons, some of them merely a response to the legislative, regulatory, and judicial environment in which they find themselves, our large investment institutions share capital primarily with large corporations. This combination must be encouraged to shift and flow of capital must be restored to our small- and medium-sized businesses. I believe that the Bill referred to as S. 285 confronts, head on, the issues of reducing the interrelationship between the institutions and large corporatoins and returning the flow of equity capital to smaller businesses.

I have some specific thoughts on the Act proposed and would like to offer them for your consideration. The 5% limitation feature of Section 2 accomplishes two substantial benefits in my mind. The first is that it should substantially reduce the potential for control which investment institutions may attain over corporations in which they intend to make heavy investments. Secondly, the excise tax which may be levied in the case of a violation should force a broader distribution of capital investments beyond the large companies to include medium and even small organizations.

I would, however, like to see more carrot and less stick used to accomplish the same results. I would like to see an incentive provided to induce financial institutions to redistribute and spread out their present investments. Under Section 2, managers of pension accounts would not be forced to dispose of current stock holdings because, under the excise tax approach of this Section, the Act properly has no retroactive effect. As it now stands, Section 2 may instead have the undesirable effect of locking in the concentrated investments already made in various select large entitites by the institutions. So, if a manager's current holdings include investments which exceed the 5% limitation, he may not be willing to trade away his control and come within the purview of the Act, and then the Act be prevented from reassuming his former position of control.

One approach suggested to me which may provide an incentive for existing concentrated investments to be distributed over a more productive profile of investments is to tax capital gains from the sale of securities of large corporations at a low rate or on a tax free basis provided that the funds are reinvested within a defined period in small or medium-sized businesses. Thus, a means of freeing up capital currently locked up by the present high capital gains taxes would be provided.

Also, perhaps Section 2, as now written, should be moderated by reducing or eliminating altogether the 100% tax applying to violations uncorrected within 180 days. It seems to me that the 5% tax alone should constitute enough of a deterrent to bring about the conduct desired by this legislation.

There is no doubt that Section 3, in modifying the prudent man rule to the extent provided, will give fund managers more latitude in exercising discretion over the placement of investment funds. Within the framework of freedom to invest in securities of any corporation with a capital account less than $25 million, or any investment company which invests primarily in such securities, the fund manager will be able to return to sound investment decisions based on such factors as risk/return ratios. What I would respectfully suggest is that leeway for this purpose ought to be provided for substantially more than a mere 2% of trust assets. Also, consider that leeway funds ought to flow into corporations with capital accounts as high as $100 million.

Without this Act, investment fund managers in the present legislative and regulatory climate must continue to be blind to the needs of potential of the majority of the business world. This Act will induce fund managers to look for and find the potential awaiting them in small- and medium-sized corporations. After all, as previously mentioned, the quantum jumps in the technological progress of the United States have sprung from small enterprises. We simply cannot look to the large, mature companies, with their entrenched interests in existing technology, to initiate the new product and new market innovations which are the trademarks of the entrepeneur.

This Bill is a good move in the right direction. It not only benefits the pensioners by seeking to improve pension portfolios, but serves the needs of small and medium businesses as well. Further, it would allow some of the pension funds of small- and medium-sized businesses to invest in the securities of corporations of like kind and size, rather than being constrained to place all their investments into the securities of giants with whom pensioners may have little sympathy or understanding. In the process, the great potential for continued growth across our entire economy will be rekindled.

Other incentives are necessary, of course, to further encourage investment in the under-capitalized businesses upon which in truth our economic future, and indeed our safety, depends. Earlier I mentioned capital gains' treatment as a possible incentive. In general, taxation has adversely changed the traditional risk/reward balance. Before burdensome taxation, more risk capital was encouraged to flow into companies and industries with high potential for growth. The risk which entrepreneurs accept must be recognized and properly rewarded if viable growth within our economy is to continue. Today, we have the Tax Reform Act of 1976 which has taken reasonable after-tax rewards away from the entrepreneur. There is no more incentive for the individual who sticks his neck out.

If I may add a personal note here, I have taken considerable risk and have played a major part in the financing of MRI Systems Corporation and its product which I believe to be of some small importance to this country. At least, it has provided employment for more than 190 people. In any event, I would not attempt to start such an enterprise in today's tax and investment climate.

We must work together to restore the proper economic environment in this country, one which will foster continued growth and new growth industries. If we are to solve our employment and social problems, we have no other responsible choice. I believe S. 285 is a step in the right direction.

Statement of John E. Jones

Mr. Chairman and members of the Committees, I am John E. Jones, President of Cummins-Allison Corporation, which is headquartered in Glenview, Illinois. Cummins-Allison is a privately-held business which was established in 1887. After 90 years of growth, our gross sales are approximately 20 million dollars supported by several hundred employees. Our products and services are offered worldwide. We develop, manufacture, and market optical and MICR scanners, Key Scan multi-media data entry systems, merchandise tag readers, perforating machines, endorsers, counter imprinters, check signers, payment books, coin processing equipment, and paper shredders, among other products.

Cummins participates in data processing with its Key Scan systems, which constitute a family of key-to-disk scanning and check processing systems. The visible feature of our systems is an operator station which consists of a CRT (cathode ray tube) display and a keyboard.

I mentioned that my company is a private corporation. It is not that we do not need the capital which would become available through going public—indeed quite the contrary is true. We have not gone public for the reason that we have been effectively foreclosed from the public equity markets. Cummins has sought equity capital funds from institutions. The institutions we approached weren't even interested in talking with us. Now, I feel that there is no use even in trying.

Foreclosed from the equity markets, Cummins has been limited to debt financing to sustain its steady growth of between 10 percent and 15 percent per year. Funding through retained earnings has been severely limited by the debt structure of the financing available to us. The bulk of our product offerings are in the data processing industry where market factors dictate that the equipment be leased to customers as opposed to being sold outright. To finance our inventory of products on lease, we have a tremendous requirement for cash. Our banks have been very helpful to us in that they have bought the future income streams anticipated for our rental contracts with customers, providing us with sufficient funds for us to remain in the marketplace.

The disadvantage in factoring our rental contracts, as we have done with the banks, is that the cost of such debt financing is approximately 10 percent to 12 percent of the present value of the contracts which we could otherwise reinvest, achieving even greater potential for growth. With a more favorable investment climate, with the availability of external equity capital to Cummins, I feel its growth rate could increase to 25 percent to 35 percent over the next three to five years.

I base my estimates on my perception of an immense market for Cummins' MICR and OCR check-processing systems. We simply cannot get the financing we need to fully participate in the check-processing industry. We simply cannot participate in the extent desirable because we can only borrow to bank-imposed limits on our asset base. We don't fault our bankers for this—as I've already said, they have been very helpful to us. Bankers can only do so much against a company's limited equity position. Debt to equity ratios must be maintained within reasonable limits.

What I am saying is that there is a trade-off between what is safe to borrow and penetration into industry markets. With more equity to balance a company's debt structure, a smaller company can achieve deeper market penetration to retain market position against any aggressive tactics by large companies. External equity financing can only be made available through a healthy investment climate. It is not just Cummins that suffers in today's unhealthy investment climate. With heightened growth, my company could hire more employees and provide those employees with even greater benefits. I believe that prospective investors in Cummins would also benefit, as would the industries to be served by the increasing availability of our products, and we would add our modest contribution toward a positive U.S. balance in foreign trade.

I support the underlying objectives of S. 285 both because of the equity plight of my company and my awareness of the need for pension reform from my perspective as a chief executive officer. Section 2 strikes at the heart of the unavailability of capital to small- and medium-sized businesses. It should force pension-fund managers to break from the few select securities enjoying a surfeit of capital under the control of the funds. I realize too well that one cause of the unavailability of capital is that the large institutions have married themselves to the very large corporations, cutting off small- and medium-sized companies from the capital markets which they control.

The severity of the effective capital shortages experienced by smaller companies is further explained by the fact that all sophisticated investors are fund watchers. In addition to the private communications between investors and brokers and brokers an institutional managers, publications periodically report the trading activity of financial institutions. In recent years, investors have recognized the institutional control over the public stock markets and have paralleled the actions of the fund managers, who parallel one another.

Hopefully, Section 3, which provides for a modification of the prudent man rule, should allow these fund managers to look to smaller businesses for the placement of the funds under their control. I personally would like to see a much larger percentage of trust funds come within Section 3 investments. Furthermore, more companies ought to benefit from this leeway provision than just companies with capital assets of less than 25 million dollars.

I believe more must be done for pension and capital formation reform. Specifically, dealing with the cost and paperwork burdens of ERISA requirements is a "pain in the neck." Such burdens discourage small and medium-sized businesses from participating in the benefits offered by pension plans. The benefits continue to accrue to the giants of industry who are able to take the costs and administrative burdens in stride.

Capital formation could be enhanced by additional specific reforms, such as a return to lowered taxation of capital gains. Favorable capital gains' treatment would provide a necessary incentive for all investors of capital to contribute toward and share in the growth potential of our economy.

The elimination of the double taxation of dividends may also provide some relief. However, such tax reform would tend to benefit only the larger companies who are able to pay dividends. Certainly, if dividends were treated as a deductible expenses, as is interest on borrowings, equity capital would be more competitive with debt equity.

But in any case, we cannot trade capital gains' reform for the elimination of double taxation of dividends, as was reported to be President Carter's intention in a June 19 *Washington Post* article. Growth companies cannot afford to pay out substantial dividends, if indeed they can pay them out at all, since the earnings before any declaration of dividends must be used to finance growth. If the *Post* reporting is accurate, the elimination of favorable treatment of capital gains would further isolate the small- and medium-sized companies from the capital markets and, with dividend deductions available to the larger companies, the capital drawing power of the large corporations over the financial markets would be assured.

I would like to assist you in any way that I can when you address the broader ramifications of capital formation reform. I commend the initiation of reform embodied in this Act before us today.

Report of the SBA Task Force of Venture and Equity Capital for Small Business

U.S. SMALL BUSINESS ADMINISTRATION, JANUARY 1977

CONTENTS

Summary of Specific Recommendations Made by the Task Force

Tax laws and regulations

Increase the corporate surtax exemption from the present level of $50,000 up to $100,000;

Allow greater flexibility in depreciating the first $200,000 of assets;

Permit investors in qualified small businesses to defer the tax on capital gains if the proceeds of the sale of a profitable small business investment are reinvested within a specified time and other qualified small business investments;

Increase the deduction against ordinary income of capital losses in a small business investment made under Section 1244 of the Internal Revenue Code from $25,000 in annual deduction to $50,000, and increase the limit on an offering from $500,000 to $1,000,000 and on issuer size from $1,000,000 to $2,000,000 in equity capital;

Permit underwriters of the securities of smaller businesses to deduct a loss reserve against the risks inherent in the underwriting and carrying of such securities;

Revise methods by which revenue impact of tax changes are estimated to reflect revenue gains from the business use of tax savings and the stimulus to capital formation that tax incentives provide.

Small business administration (SBA)

Provide that some portion of the guaranteed borrowing available to SBICs take the form of debt with the interest partially subsidized, if the funds are used to make equity investments;

Permit SBICs a deduction from ordinary income for loss revenues on both the equity and debt portions of their portfolios;

Immediately make a substantial increase in the size standards for SBIC investments and also provide for either an annual revision of these standards or index them according to broadly accepted price indicators.

FOREWARD

In July 1976, Mitchell P. Kobelinski, Administrator of the U.S. Small Business Administration (SBA), appointed a Task Force on Venture and Equity Capital for Small Business to assess the financing problems facing the small businessman today and to recommend solutions. The Task Force was made up of 15 people actively involved in managing, financing or advising small businesses. It is grateful for assistance provided by officials from the SBA, the SEC, the Treasury and Labor Departments, and private financial institutions.

The Task Force met several times as a full group and more frequently in smaller subcommittees. Early in the discussions it became apparent that the scope of the study had to go beyond just the provision of venture capital to very small businesses, because of the interrelated nature of all forms of capital required by business.

The Task Force believes the implementation of the study's recommendations can make a vital contribution to America's free enterprise system. If the recommendations included in the Report are favorably acted upon by the Administration and the Congress, it is the opinion of the Task Force that critically needed new venture and equity capital will flow to the small business sector of our economy, which in turn will produce substantial increases in jobs, tax revenues and productivity.

SBA should require and encourage commercial banks to assume a larger portion of the risk in SBA loans and change its guarantee fee from on one-time fee of 1 percent of the amount of the guaranteed debt to an annual fee which more nearly reflects the value and cost of SBA's guarantee;

Substantially expand SBA's Secondary Market Program by creation of a "Certificate" system for the sale of SBA-guaranteed loans.

Institutional Investors/Employee Retirement Income Security Act (ERISA)

Amend ERISA to declare a policy that pension funds may invest in a broad spectrum of American companies within the "prudent man" rule and that it applies to the total portfolio rather than any individual investment. Also create a "basket" of 5 percent of the assets of any plan within which investment managers can invest according to standards of prudence and liquidity appropriate to higher risk small business investments;

The development of professionally managed pools of capital should be encouraged so that pension fund managers, otherwise constrained by time or expertise, may participate in the investment in new ventures and in growing smaller companies. These special funds should be specifically exempted from the provisions of the Investment Company Act of 1940;

In cooperation with the SEC and other regulatory bodies, exempt the illiquid securities of small companies from "mark-to-market" or "fair value" accounting treatment.

Securities laws and regulations (SEC)

Increase the small offering exemption from $500,000 to $6,000,000;

Enactment the limited offering exemption as proposed in the American Law Institute project to codify the securities laws;

Retain and simplify Rule 146;

Amend Rule 144 to provide that the existing quantitative limits apply for only a three-month period rather than a six-month period. In addition, change those limits to one percent of outstanding shares or the average weekly volume, whichever is higher instead of whichever is lower;

Develop procedures under which solicitation, with appropriate compensation to develop a market, may be undertaken if buyers are provided with copies of financial data and other disclosures regularly filed with the SEC along with a supplemental statement on mode of offering, identity of underwriters, price of securities offered, and information needed to update the data on file with the SEC.

INTRODUCTION

Small businesses comprise 97 percent of all unincorporated and incorporated businesses in the United States. More than half of all business receipts are generated by their operations. Perhaps more important, they employ more than half the U.S. business work force.

It is a matter of acute concern that, in the face of clearly emerging needs and the documented benefits to the United States economy, a set of impediments have developed that are preventing smaller businesses from attracting the capital without which they cannot perform their traditional function of infusing innovation and new competition into the economy. Unless these impediments are overcome, the ability of the economy to compete in the world and meet the needs of the American public will be seriously eroded.

It is alarming that venture and expansion capital for new and growing small businesses has become almost invisible in America today. In 1972 there were 418 underwritings for companies with a net worth of less than $5,000,000. In 1975 there were four such underwritings. The 1972 offerings raised $918 million. The 1975 offerings brought in $16 million. Over that same period of time, smaller offerings under the Securities and Exchange Commission's (SEC's) Regulation A fell from $256 million to $49 million and many of them were unsuccessful. While this catastrophic decline was occurring, new money raised for all corporations in the public security markets increased almost 50 percent from $28 billion to over $41 billion.

A public policy that discourages the public from investing approximately $1 billion a year of its savings in economic innovation, growth, and the creation of jobs while it encourages the public to risk $17 billion a year in Government-sponsored lotteries, requires close and serious reexamination.

Impediments to small business growth

In this context, the Task Force sees in the American business and financial scene today the following characteristics:

1. A public policy that tilts sharply towards encouraging consumption and discouraging savings and investment.
2. An increasing and dangerously high ratio of debt to equity arising in part from artificial tax advantages extended to debt financing.
3. Distinct impediments to raising equity and other forms of risk capital.
4. Savings gravitating towards larger institutions that are discouraged from investing those savings in smaller and new businesses.
5. Well-intentioned efforts to protect investors which inadvertently place small businesses at a disadvantage in competing for available funds.
6. Attrition and concentration in the network of financial institutions and firms that has served our economic needs well by mobilizing capital.

A recent study by the Massachusetts Institute of Technology Development Foundation has arresting data on the importance of new companies and new technologies to property and jobs in America. It compares the performance of six mature companies, five innovative companies, and five young high-technology companies. From 1969 to 1974, the average annual contributions of these companies in jobs and revenues shaped up as follows:

[In percent]

Type of companies	Sales growth	Job growth
Mature	11.4	0.6
Innovative	13.2	4.3
Young high technology	42.5	40.7

Although these young companies are not only growing faster but actually creating more new jobs and tax revenues than the giants of American industry, we see increasing impediments to this same opportunity for other new companies.

Recent economic trends have caused all investors—institutional, large nonfinancial companies, venture capitalists, individuals and local bankers—to become more conservatives in their investment policy. Recent legislation and regulation, however well intentioned, has added to that conservatism by cutting incentives to take risks. Savings and other financial resources, so desperately needed by small companies to finance their growth, have become concentrated in larger financial institutions. For example:

Since 1962, deposits in the ten largest banks have increased from 20 to 33 percent of all deposits.

Pension funds assets have tripled since 1962 and it is estimated that by 1985 more than half of all equity capital will be in the hands of pension fund managers.

Mutual funds assets have doubled in the same time period.

Institutions now account for 70 percent of the volume of trading on the New York Stock Exchange (NYSE).

As assets have concentrated, access to them has become more difficult, particularly for small businesses. In the past 5 years, the number of registered securities broker/dealer firms has declined 35 percent, and the number of registered representatives has declined as well. The Task Force has found that this shrinkage of the securities industry has compounded the problem of providing smaller companies with access to capital. Large institutional investors handling pension funds, wary of standards set forth in the 1974 Employee Retirement Income Security Act (ERISA), are concentrating their funds in larger companies with proven records to avoid possible lawsuits and liabilities under ERISA.

Individual investors, once a vital source of funds for new businesses and liquidity for early investors, have been so hurt in recent bear markets that they are reluctant or unable to provide risk funds again. In addition, the incentive for individuals to risk capital in equities has been drastically reduced by a capital gains tax rate that today can run from 70 to 100 percent more than the maximum rate that prevailed as recently as 1970.

Compliance with Government regulations—tax returns, registration statements, ERISA reporting requirements, and a great variety of reports and surveys—constitutes a heavy burden for the small businessman. Although highly commendable efforts to lighten this load are under way, the small business today is in grave danger of smothering under the weight—and cost—of repetitive paperwork.

One of the more serious problems is the skyrocketing cost of entering the public market to seek new sources of financing. An analysis of six of the smaller offerings made in 1976 by companies having assets of less than $5 million shows the average cost of registration is $122,350, an automatic and, in some cases, insurmountable roadblock for companies interested in entering the public market.

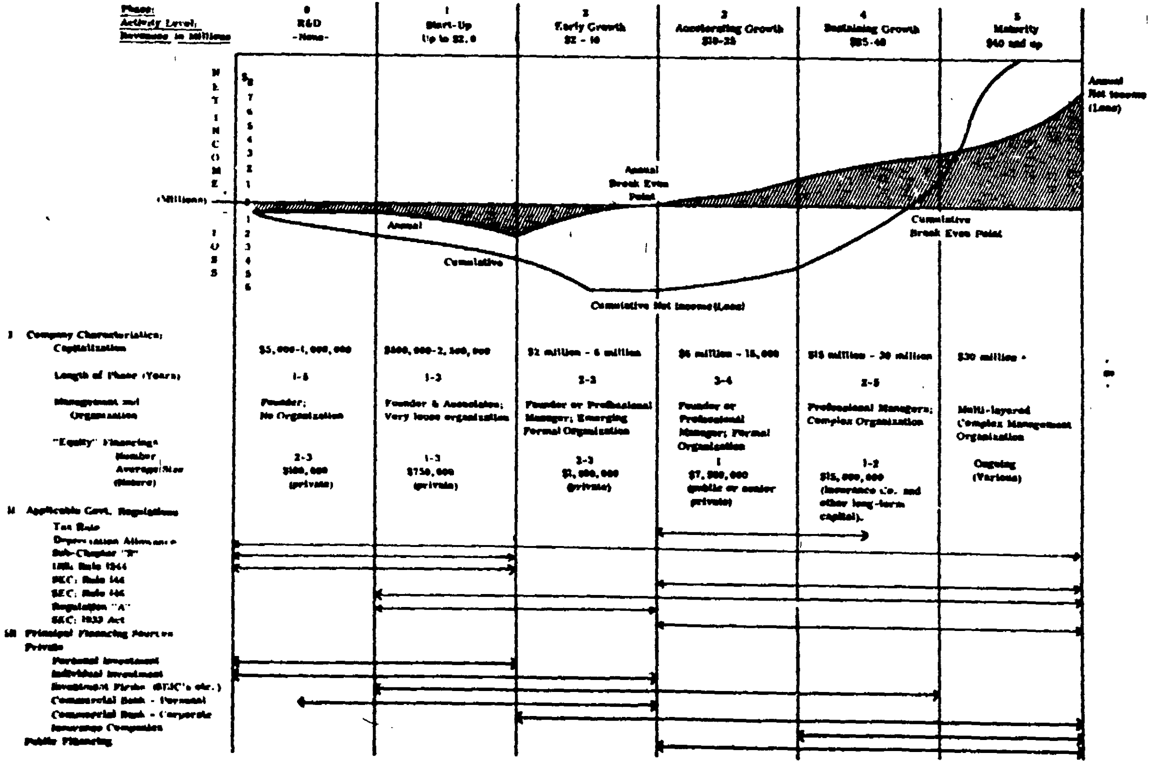
The life cycle of growing businesses and its financing

The result of all these trends has been to make economic growth for smaller companies increasingly difficult. The chart on the next page illustrates the stages a company must go through to achieve maturity as a corporate entity.

The cycle of a business enterprise requires different types of capital at each stage of its life. The highly developed U.S. marketplace has spawned investors for each of these many stages. The result can be imagined as a financial pipeline along which successful companies move from start-up to maturity.

If this pipeline flows smoothly, all types of investment capital can function. If it clogs at any point, capital dries up all along the pipeline. Facilitating the turnover of initial investments to more conservative investors is critical to unblocking the flow of initial higher risk investments in smaller businesses. In fact, the Task Force believes that creating better prospects of liquidity for early investors will, in itself, restore the flow of equity investment in the early stages of business life. Hence the Task Force focused on institutional investors and the public stock market, in addition to other sources of risk capital, internal financing and long-term debt financing.

LIFE CYCLE OF A NEW ENTERPRISE
MODEL OF A GROWING AND SUCCESSFUL COMPANY
1975-1976 FINANCIAL MARKET CONDITIONS



Traditionally, businesses have used a mixture of internal and external financing for their needs. Small businesses cannot grow very fast if they have to finance themselves solely out of their earnings. In most cases external sources must provide the financing for significant growth.

As shown on the chart, however, a hypothetical company moving through the system must reach a revenue level of up to $10 million before public financing becomes even remotely possible. Moreover, it is not until a business reaches revenues of $25 to $40 million that all sources of public and private funding become, in some measure, available.

Though Government agencies provide a great deal of assistance to small businesses through agencies such as the Small Business Administration (SBA), there are legislative limitations on this agency's programs that prevent them from being completely responsive to the small businessman's needs for equity capital. Because private financial resources are at times unavailable, the small businessman is often faced either with stagnation or the sale of all or part of his company.

In addressing the financial needs of small businesses and the impediments to meeting them, it soon becomes apparent that the problem is different for:

(*a*) The many small businesses that are local in character or so family owned and managed that they would be unlikely to have or want access to the public securities markets; and

(*b*) Those businesses that can develop so that they will need access to public financing.

There are different remedies called for with respects to these two broad categories of smaller businesses.

There is a cycle of financial events and opportunities into which new and growing businesses have to fit themselves to finance their growth and expansion. This cycle starts off with the ability to save and the will to commit those savings in order to start a small business. Here, if public policy is to reflect the contribution new and small business can make to the national welfare, our tax system has to encourage necessary savings and the commitment of these savings to new and small businesses.

Then, after a new business is launched, the tax system should permit it to generate sufficient internal capital so that a growing equity and credit base will enable it to meet growth requirements. This can be done with some deferral of tax payments; allowing small businesses greater flexibility in charging off the assets needed to do its business; and an increase to reflect inflation in the amounts to which small business tax treatment now applies. This will provide greater revenues for the Government in the future as small businesses use this increase in internal financing to provide additional jobs and greater taxable wages and profits.

From among the new and small businesses that grow as a result of these tax revisions, a few will show a potential for generating jobs and profits that are sufficient to attract funds from private, public and institutional investors. These businesses should be able to compete for these funds on equal terms with older, larger and more established businesses. Savings will not be invested in these new and growing enterprises unless the investors can efficiently convert their investment to cash over time without undue penalty. The seed money needs of these innovative and growth-oriented businesses used to be met by knowledgeable investors found in towns and cities all over America. In the last fifteen years, a significant portion of this activity has become institutionalized and professionalized in enterprises having risk money together with experience and skill in identifying unusual business opportunities in technological developments and emerging needs.

Today however, surveys of the investing activity of leading professional venture capitalists, having total assets estimated at $1.7 billion and investing in excess of $100 million per year in venture capital situations, show an increasing proportion of their funds going to established companies. In 1975 only five percent of new investments went to startups of new ventures and two percent to first-round financings.

This represents a sharp reduction from previous years. Most venture capital firms have adopted a policy of staying away from start-ups and have put their available capital in safer and more liquid investments. The Task Force believes this steady shift towards a more conservative investment policy comes from perceived difficulty in recycling investment funds as restrictions on the access of small and growing business to the public securities markets has become more costly and difficult.

COMPANIES WITHOUT ACCESS TO PUBLIC SECURITIES MARKETS

The very small business, usually local in character, is likely to be launched on the personal savings of family and friends by an entrepreneur interested in full ownership and attracted to the prospects of financial reward.

His primary financial advisor will usually be his local banker, who provides advice, counsel and, more importantly, short-term credit for his generally under-capitalized enterprise. Local bankers are likely to go as far as conventional economic wisdom and prudent banking standards permit in granting loans on the basis of confidence and character. Certainly the banker cannot be adequately compensated for making this type of loan because of the risk and servicing involved. He, and the entrepreneur, are taking calculated risks, hoping for greater rewards—increased deposits and profits—in the future.

With these loans and private resources, the entrepreneur begins his business with a reasonable relationship between debt and equity capital. If the business prospers, he approaches his banker for funds to purchase additional inventory or to handle his multiplying accounts receivable. He continualy borrows short term, being fully convinced that he will have funds to repay within the 30-day term of the loan. The banker, pleased with this progress, continues to advance funds, all in short-term notes renewed and rewritten at regular intervals. This satisfies the bank's needs to adjust loan interest rates quickly and to show liquidity on its books.

As this small business grows, however, the availability of this type of financing fades away as its dangers emerge. Short-term indebtedness goes up and retained earnings are unable to grow as fast as the business. Paradoxically, the more profitable the business is, the worse its financial statement looks because of the high ratio of debt to equity.

As internal financing becomes increasingly difficult, the entrepreneur's external source of financing, his banker, may begin to run into loan limit problems. Moreover, as more and more local banks are absorbed by large banks, the entrepreneur may find himself faced with a more impersonal and cautious branch manager, who may not want these small business risks.

The entrepreneur begins to realize the value of long-term financing. He turns to the government for help, in most cases to the SBA. He finds that this agency's programs of direct and guaranteed loans, and equity financing through SBA-licensed Small Business Investment Companies (SBICs), may be able to provide necessary assistance. Yet this assistance, too, has its limits.

Tax revisions to facilitate internal financing and attract capital

The fact is that for those businesses not likely to require or want to raise money from the public, capital growth needs must come from a combination of internal cash flow and from borrowing. To make it possible for many thousands of small businesses to realize their potential in growth and jobs, reform in the tax structure is essential.

The most direct and effective step that can help small business is to bring the $50,000 of corporation earnings now taxed at a lower rate in line with inflation and the escalation of risks and higher costs in starting and carrying on business. Consequently, the Task Force recommends the corporate tax rates be modified so that the first $100,000 of corporate taxable income should be at lower rates, as follows:

First $50,000; 20 percent.
Second $50,000; 22 percent.
Excess over $100,000; 48 percent.

Allowing these small businesses to use a larger portion of their first $100,000 of earnings to grow will produce additional revenue and jobs. The Government will benefit from additional taxes and a reduction in welfare and other unemployment costs in the future.

Allowing small businesses greater flexibility in writing off the first $200,000 of depreciable assets is another step that should be taken to increase the internal financing that is so critical to businesses in their early years.

The higher capital gains tax rate has altered the risk-reward relationship for investors. This is likely to have its greatest impact on equity investment in small businesses where capital is already scarce and the risk of loss is greatest. This was recognized by Congress in 1958 with the enactment of Section 1244 of the Internal Revenue Code that allows limited deduction of loss in a small business investment against ordinary income. To reflect inflation and increased capital costs in new businesses, the limitations surrounding this provision should be increased so that deduction of $50,000 instead of $25,000 is permitted a taxpayer in any one year. The limit on issuer equity capital and size of the financing necessary to qualify should be increased respectively from $1,000,000 to $2,000,000 and from $500,000 to $1,000,000.

The capital gains tax has become so high that it no longer serves as an incentive to provide long-term investment capital. Deferring that tax as long as these funds remain invested in small business can provide a major incentive to attract the individual investor back to investing in small companies. The Task Force recommends that investors in qualified small businesses should be permitted to defer the tax on capital gains if the proceeds of a profitable sale are reinvested in another qualified small business within a specified time period. There is ample precedent for this kind of deferral in home sales, condemnations and retirement plan distributions. Since small businesses are potentially the most rapidly growing part of the equity investment spectrum, the ultimate tax revenues can be significantly higher, more than offsetting the cost of deferring revenues.

These tax revisions will result in a reduction of some tax revenue and deferral of other revenue. The Task Force takes issue with the method currently used in the Treasury's forecasts of the revenue impact of tax legislation. These revenue estimates reflect only the reduction in tax collections from tax revisions without any offsetting allowance for income which will result from retaining and using the revenue reductions in business activity. Nor does it reflect the stimulus to capital formation and economic activity which greater incentives will provide. The Task Force believes that a more accurate and balanced method of evaluating the impact of proposed changes is essential to developing sounder tax policy. It recommends that, at the earliest possible date, the new Secretary of the Treasury review the methods now used to forecast the revenue loss from tax changes.

SBA assistance in long-term borrowing

The tax revisions discussed above will allow small companies to generate more substantial cash flows internally and, thus, attract greater financing from their banks. Beyond that, if small businesses are to be restored to their full role in contributing to national economic growth and generating jobs, the financing role of SBA should be strengthened. Therefore, the Task Force believes it important that SBA programs be put on a more self-sustaining and flexible basis.

The SBA is to be commended for steadily shifting its emphasis from direct loans to the guarantee of bank financing. In this way SBA has increasingly utilized the more intimate knowledge of local businesses and local economic risks and opportunities and the greater ability to supervise loans which local banks almost invariably have. At the same time it has provided small businesses with long-term financing that local banks, subject as they are to the requirements of regulatory agencies to keep their assets liquid and maturities short, have not been able to provide.

The SBA is also to be commended for helping local banks to bring institutional funds into small business financing by instituting its Secondary Market Program. Under this program, banks making SBA-guaranteed loans can now sell them to other investors to improve the banks' liquidity and bring new funds into local financing by offering Government-guaranteed, good yield investments to institutional and other investors. Since the program's inception through September 1976, more than $400 million of these loans have been sold to investors who would find it difficult to lend directly to small businesses. This successful Secondary Markets Program should be substantially expanded. The SBA-proposed "Certificate" system would transform the guaranteed portions of SBA loans into freely transferable market securities. This would tap additional institutional investor sources of capital, remove bankers' reservations about liquidity and reduce bank examiners' concerns over long-term loans in banks' portfolios. In order to ensure full utilization of these new resources, a comprehensive public information program aimed at small businessmen should be instituted.

The Task Force believes that SBA can strengthen its ability to contribute to the financing needs of small business by placing its operations on a more businesslike basis in two very important respects:

1. Requiring and encouraging commercial banks to assume a larger share of the risk in the long-term financing that SBA facilitates through its guarantee. For example, the SBA might require banks to retain 15 percent instead of 10 percent of the risk in these loans and use a sliding guarantee fee to induce banks to take an even larger portion of the risk.

2. In extending a seven-year guarantee for a one-time fee of one percent SBA is not being adequately compensated. Additionally, there is little or no incentive for either the borrower or the lender to do without the guarantee. A basic guarantee fee of one-half to one percent a year would still be a bargain to most small businesses. An increase in the fee would also place some limitation on the demand for SBA's guarantee and more adequately offset the lossess SBA sustains in extending its guarantee.

The Task Force recognizes that these steps will increase the cost of SBA financing. However, the availability of financing is more important than such a modest increase in cost. These steps will bring SBA activities closer to a self-sustaining basis. This should encourage the Congress and the Office of Management and Budget to increase the SBA guaranty authority as small businesses and local banks show a readiness to share more of the risk and pay a more realistic price for SBA-assisted financing.

Strengthening the Small Business Investment Company (SBIC)

SBIC's are an important source of long-term debt financing and equity and venture capital for small business.

Although SBICs provide a significant amount of pure equity financing, there hase been a tendency for them to increase their holdings in loans and other debt instruments of small businesses. The major incentive for the creation and operation of SBICs is the availability of long-term Government-guaranteed loans that require very modest equity and provide attractive investment leverage to those supplying equity capital for an SBIC.

This leverage has from time to time been increased by law. To meet the interest cost of these increased borrowings, SBIC investments have tended heavily toward interest bearing debt securities, rather than common stock. This has a tendency to add to the debt burdens of the smaller business rather than providing the permanent capital that this size of business so badly needs.

To resolve this problem, the Task Force recommends that some portion of the Government loans providing SBIC leverage be available in the form of debt, on which interest is partially subsidized. This would relieve the pressure on SBICs cash flow and enable them to make more pure equity investments.

Another disincentive for SBICs to take risks is the tax treatment of loss reserves. Currently, SBICs may establish a loss reserve for only those investments which are in the form of debt securities. The Task Force recommends that SBICs be authorized to deduct loss reserves from ordinary income on both the equity and debt portions of their portfolios in order to encourage more equity investments.

SBA has partially adjusted for inflation by increasing its size standards for SBIC investments. However, these adjustments tend to lag behind the realities of the marketplace. Therefore, the Task Force recommends that SBA adjust its size standards for SBICs annually or that these standards be measured against broadly accepted price indexes.

COMPANIES SEEKING PUBLIC CAPITAL

Small businessmen whose enterprises survive and thrive may find it necessary to seek external financing from investors having more substantial and varied capital resources than commercial banks and the SBA. There is a new set of obstacles on this road to economic growth.

The access of small companies to public markets, particularly in the early 1950's, encouraged the formation of venture capital—money that was available for innovation and small business growth in the hope that some of the funds invested could be recovered within two to five years.

Venture capitalists, however, like all investors, found that the years following 1969 were difficult ones. They were forced to cut back on investments in many new ventures, because without a lively secondary market for resale of these securities, underwritings do not take place. Without underwritings, there are no investments, and the economy suffers. The table below illustrates the precipitate decline in offerings and money raised for companies having net worth of $5 million or less.

Year	Number of offerings	Total amount (millions)
1969	548	$1,457.7
1970	209	383.7
1971	224	551.5
1972	418	918.2
1973	69	137.5
1974	8	13.1
1975	4	16.2

The first stages of market recovery in 1975–76 have not been strong enough to rebuild confidence, particularly that of individual investors, in the new issues market.

Making institutional funds more available to small business

Institutionalization of the stock market has meant that the small businessman must appeal to a professional investor who has a large amount of money and limited time to analyze potential investments. Increasingly, a major source of capital in America is the money in pension and other employee trusts. Fiduciary standards created by ERISA, however, have isolated about $200 billion of money in these trusts from all investments other than large blue chip, and fixed income securities. Attorneys advising trust officers have interpreted ERISA regulations conservatively, although they do not differ significantly from commonly practiced standards of fiduciary responsibility. As a result, trustees are reluctant to invest in companies without strong earnings records. Most pension trustees find it neither economic or prudent to invest in companies without a capitalization large enough to give investors liquidity. It appears that the market value of a firm must be over one hundred million dollars to interest pension funds managers.

ERISA should be amended in two important respects:

1. To expressly declare a policy of allowing pension funds to invest in a broad spectrum of American companies by clarifying ERISA's "prudent man" standard so that it is clearly applicable to the total portfolio of pension fund investments rather than individual investments, and
2. To relieve pension fund managers of ERISA restrictions in investing up to five percent of pension fund assets in companies having less than $25 million in net worth and larger companies having limited marketability for their securities.

These modifications should be designed to encourage the development of professionally managed pools of capital to assume responsibility for segments of the portfolio that pension fund managers do not have the time or experience to effectively invest in new ventures and growing companies. The SEC should exempt these special funds from the time-consuming and cumbersome requirements of the Investment Company Act of 1940.

The current interpretation of Financial Accounting Standard Boards regulations has led to substantial short-term profit and loss impact on portfolios. These standards require portfolio managers to value these holdings of unregistered securities and report the resulting portfolio changes as profit or loss, even though no transactions take place. These fluctuations in both valuation and profit and loss are arbitrary and time consuming. Requiring "fair value" accounting creates the onerous task of frequently evaluating the current fair value of investments in small company securities. Most institutions avoid this by simply staying with only large, marketable equity securities or high quality debt securities. It would be consistent with the principle of materiality to waive the requirement for fair value accounting for investments made within the five percent "basket" provision we have recommended.

Small business access to the public securities markets

The small businessman will find more and more securities firms disappearing with changes that have taken place in brokerage economics. Fixed commission rates have been eliminated and rates are governed by competitive and free market forces. Principal beneficiaries of this change have been institutional investors, not individual investors.

All these forces have substantially dried up access to the securities markets for small businesses. There are fewer regional securities firms, fewer registered representatives, fewer trading desks and research facilities.

Today, most underwriting is by the "majors", and these "majors" will not generally underwrite companies with annual earnings of less than $2 million. The few remaining strong regional brokers are working almost exclusively with firms whose earnings are between $1 million and $2 million.

To keep small firms with growth potential from being shut out of the public securities market the SEC created Regulation A (based on the small offering exemption in the Securities Act of 1933). This facilitates securities offerings of $500,000 and less by exempting them from the costly and time-consuming undertaking of full registration. This is not much capital for a growing company in the light of today's needs and the value of today's dollar. The Task Force commends SEC Chairman Roderick Hills for recommending that the Regulation A exemption be extended to offerings up to $2 million. However, it is impressed by the need for the underwriting of most Regulation A offerings as shown by the SEC's finding that, during the period 1972 to 1974, in 546 Regulation A filings only 35 perecnt of the shares offered were actually sold. Since few firms in the contracted securities industry will underwrite an issue of less than $3,000,000 today and firms which do handle small issues are anxious to take advantage of the savings in time and cost which Regulation A makes available, the Task Force believes the limit should be increased to $3 million.

Congress also provided a private offering exemption in enacting the Securities Act of 1933. Administrative and court interpretations have so narrowed the scope of this exemption that investors in very small financings have been able to change their minds and get their money back simply because the offering had not been registered. The buyer of stock who is defrauded has been provided with an effective remedy by the SEC through its development of Rule 10b(5). Requiring a small business to register a limited financing under pain of having to return the proceeds in the absence of any fraud was never intended and Congress should take legislative action to restore the private offering exemption.

The SEC developed Rule 146 to provide a safe harbor for private offerings that claim the private offering exemption and do not register. The SEC is to be commended for an imaginative effort to clear up the difficulties created by the attrition of the statutory private offering exemption. However, this Rule will necessarily be cumbersome, complicated and burdensome until Congress acts to restore the original intent of the private offering exemption. Meanwhile, there are modifications in Rule 146 which can be helpful and the Task Force recommends Rule 146 be modified in two respects:

1. In the "information to be provided" provision insert the words "if material" to modify the information required in the offering circular; and
2. Add a provision, along the lines of that provided in Rule 240, that failure to furnish information or an inability to sustain the burden of proof with respect to other offerees will not permit a buyer who has been properly informed to demand recision.

The limitations that the SEC has developed on the secondary sale of securities are probably more damaging to small business financing in the public securities markets than the high cost of registration and the near disappearance of the private offering exemption. If the kind of risk money that goes into new and growing businesses cannot be readily recycled it is usually not invested. It is the inability to readily convert some of the profits on successful investments back into cash that has driven professional venture capitalists away from start-ups toward companies with proven earnings records. Furthermore, this leads to the liquidation of investments through large corporate takeovers instead of by sales in the public securities markets.

Congress, in enacting the Securities Act of 1933, required registration of securities only of issuers, underwriters and dealers. Anyone else was to be free to sell without registration. Until the late sixties, it was generally considered that holding a security for two years established that it had not been purchased for resale as an underwriter and could be sold without registration. During the late sixties and early seventies, considerable uncertainty developed about restrictions on resale of securities and in 1972, the SEC issued Rule 144.

Rule 144 has been successful in bringing clarity and certainty to the requirements for the resale of securities purchased without registration. However, it has, in the view of the Task Force, created unnecessary and unjustified restrictions on the private resale of unregistered shares which contribute substantially to clogging the flow of capital to smaller businesses.

Where Rule 144 is harmful is in its effort to protect the market from selling pressure through quantitative limitations on the shares which may be sold in any six-month period. This quantitative limitation has a whole series of consequences that impede venture investing, are counterproductive to investor protection and promote concentration. The limitations on moving out of a risk investment cause venture capitalists to go in for small percentages and in lesser amounts. The restricted pace at which they are able to liquidate their investment contributes substantially to the trend to stay away from young companies and to restrict venture capital to companies which have matured or seem to be on the verge of maturing. When they do have a successful investment, the difficulty of recycling their investment through private sales gives an edge to the large company that can take over the smaller company in one bite. This, in turn, reduces competition and promotes concentration.

Moreover, as long as there are restrictions on compensation and other selling efforts, it is difficult to see why any quantitative limitation is required. The seller's interest in not driving down the price of the shares he wants to sell can be relied on to limit the shares he offers. Certainly there is no evidence to justify a limtation which extends for six months and there is ample evidence that the present maximum is usually absorbed in a matter of weeks or days, when there is any real market at all.

The Task Force therefore recommends that as a first step Rule 144 be amended so that existing quantitative limitations apply for only a three-month period instead of six months and that the limit be set at one percent of outstanding shares or the average weekly volume over a four-week period, whichever is higher instead of whichever is lower.

The Task Force is pleased to learn that SEC Chairman Hills has initiated an economic analysis to reevaluate the need and justification for a quantitative limit on resales of securities that have not been registered. It hopes that the quantitative limit will be eliminated or enlarged further if economic analysis shows that there is little or no justification for it.

The Task Force also recognizes that many small businesses do not enjoy an active market for their shares. Rule 144's prohibition against solicitation requires that there be a reasonably active market in a security if substantial amounts are to be sold. Thus, reduction or removal of the limit on shares offered will be only marginally beneficial to investors in many small businesses because of the limitations on solicitation coupled with a relatively thin market.

The Task Force therefore hopes that the SEC, and the experienced and knowledgeable Disclosure Committee it has designated under the chairmanship of A. A. Sommers, develop procedures under which solicitation and compensation required to develop a market will be permitted. The Task Force believes that active selling should be permitted when buyers are provided with copies of the financial data and other disclosures regularly filed with the Commission and a supplemental statement on the mode of offering, the identity of any brokers involved, the prices at which the securities are to be offered and any information necessary to update the data on file with the Commission.

Acquisitions and concentration

The Federal Trade Commission's 1976 report on mergers and acquisitions states: "As in the previous three years, acquired firms that fell into the smallest asset size class accounted for the highest proportion of recorded acquisitions. Acquisitions of firms in the under $1.0 million and unknown asset size class represented 985, or 76.1 percent of the total number of recorded completed and pending acquisitions. For many of the acquired companies in this category, asset figures were unavailable—most likely because the acquired company was quite small. The $1 to $9.9 million asset size class had the second highest proportion of acquired companies (11.5 percent)."

As we have already developed, limitations on the ability of private investors in successful small businesses to sell their share to other investors have resulted in large companies being able to entirely buy out successful small companies at a discounted price because the business and its individual owners have little alternative in meeting their financing and liquidity needs. This is, we believe, the major force increasing concentration and big corporation bureaucracy and diminishing competition in the American economy today.

We recognize that mergers are a legitimate means of developing liquidity. Frequently, a growing business needs the capital and management expertise of a larger partner for continued growth. On the other hand, many mergers in the past five years have been "shotgun weddings" because of an environment that offered the smaller businessman no alternative methods of acquiring capital and liquidity.

Recently, larger companies have begun selling and restructuring peripheral portions of their operations as smaller, free-standing businesses. Freer availability of risk capital to encourage divestitures of this kind can revitalize these smaller operations and provide new, challenging opportunities for both technological and personal advancement. It can also inject new forces of competition which will benefit all who participate in our economy as consumers, producers and investors.

RECOMMENDATIONS FOR FUTURE ACTION

The recommendations of this Task Force offer only partial solutions to the problems of equity and venture capital for small businesses. No solutions remain adequate for very long. Problems multiply as society becomes more complex. There is a need to deal with small businesses problems on an ongoing basis. But there are no marble palaces in Washington for small business nor are there many champions whose voices are heeded. A Task Force such as this can only provide a snapshot of the conditions which its individual members experience and observe. It should submit its report, make its recommendations, and then go out of existence. Small businesses, however, need strong ongoing advocacy aimed at creating the optimum environment for their growth. It is the considered view of the Task Force that this role should be lodged in the Office of the Administrator of the SBA.

The SBA is a small, independent Federal agency, and SBA Administrators until very recently did not sit as a member of the various advisory bodies Presidents have used in coordinating economic policies. Yet this agency could be the principal voice of half of the nation's business community. The Task Force believes the SBA Administrator should be charged with an active role on behalf of small business in a number of areas:

The SBA should expand its role as a catalyst and advocate within the government for changes reflecting the concerns of small businesses. These concerns are fragmented among many agencies and action on them often appears at random, too little or too late. The SBA should not only act to coordinate the Federal Government's activities relating to small business, but also to serve as an intermediary between various government units and private groups representing small businesses and their sources of financing.

The planning and research activities of the SBA should be strengthened and its area of interest extended beyond its SBIC and 7(a) Bank Loan Guaranty program to include the general health of the public and venture capital market as well. These studies should be directed to such specific matters as the competitive impact of option trading on market trading in shares of smaller companies and its effect—if any—on the new issue market in these shares.

As a final note, the Task Force believes the government can play a vital role in stimulating the creation of new products that can be produced and marketed by small business. Too often an invention developed with government support has become the government's invention and not the inventors. Also too often, worthwhile technology developed by the government for special purposes such as defense or space has not been commercially developed. SBA's interest in this area could stimulate the economy, and result in increased jobs and tax revenues.

If small businesses are to continue as a vital force in today's economy, their interest and requirements must be considerd and advocated vigorously. The Task Force believes that the steps outlined here can significantly increase the contributions which these enterprises can make to the U.S. economy.

SBA TASK FORCE ON VENTURE AND EQUITY CAPITAL

Mr. William J. Casey, Chairman, Counsel, Rogers and Wells, New York, N.Y., and Washington, D.C.

Mr. Robert P. Aulston III, Chairman, Gulf South Venture Corp., New Orleans, La.

Mr. Harry G. Austin, Jr., President, James Austin Co., Mars, Pa.

Mr. Paul Bancroft III, President and Chief Executive Officer, Bessemer Securities Corp., New York, N.Y.

Mr. Travers J. Bell, Jr., Chairman, Daniels & Bell, Inc., New York, N.Y.

Mr. Edgar F. Bunce, Jr., Senior Vice President, Prudential Insurance Co. of America, Newark, N.J.

Mr. Stanley Golder, President, First Capital Corp., of Chicago, Chicago, Ill.

Mr. Herbert Krasnow, President, Intercoastal Capital Corp., New York, N.Y.

Mr. William R. Hambrecht, Partner, Hambrecht & Quist, San Francisco, Calif.

Mr. Richard M. Hexter, President, Ardshiel Associates, Inc., New York, N.Y.

Mr. Charles L. Lea, Jr., Executive Vice President, New Court Securities Corp., New York, N.Y.

Prof. Patrick R. Liles, Harvard Business School, Cambridge, Mass.

Mr. Duane D. Pearsall, President, Statitrol Corp., Lakewood, Colo.

Mr. Don C. Steffes, President, McPherson State Bank & Trust Co., McPherson, Kans.

Mr. William D. Witter, New York, N.Y.

SUPPORTING SMALL BUSINESS ADMINISTRATION OFFICIALS

Mr. Mitchell P. Kobelinski, Administrator.

Mr. John T. Wettach, Associate Administrator for Finance and Investment.

Mr. Peter F. McNeish, Deputy Associate Administrator for Investment.

Mr. James B. Ramsey, Consultant.

Mr. Richard A. Runco, Presidential Interchange Executive, Special Assistant to the Associate Administrator for Finance and Investment.

Mr. John L. Werner, Director of the Office of Investment, Management, and Evaluation.

[Thereupon, at 11:55 a.m. the hearing in the above-entitled matter was recessed, to reconvene at the call of the Chair.]

PENSION SIMPLIFICATION AND INVESTMENT RULES

MONDAY, JULY 18, 1977

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS
OF THE COMMITTEE ON FINANCE AND THE
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m. in room 424, Russell Senate Office Building, Hon. Gaylord Nelson (chairman) presiding.

Present: Senator Nelson.

Senator NELSON. This session will conclude the series of six public hearings on the administration, reporting and investment policies under ERISA. The previous 5 days of testimony were taken during May and June jointly by this committee and by the Private Pension Plans Subcommittee of the Senate Finance Committee. In the course of this inquiry, a bill, S. 1745, was introduced by Senator McIntyre and myself addressed to many of the problems of small business under the new pension reform legislation.

This morning's testimony will focus on investment policies under ERISA. These policies have a direct impact on every worker and his family covered by social security or a private pension plan, and what they will be able to buy with their monthly retirement checks.

According to the Securities and Exchange Commission, pension fund assets total $445 billion, and they are among the fastest growing sources of capital. The evidence of these hearings reflects that ERISA has channeled the flow of these dollars into the highest rated bonds and the largest, most established corporations.

For example, the trustee of a fund operated by a 500,000-member independent business organization said that this fund was restricted to investment in AA or AAA bonds. We have heard informally that most pension funds will not consider an investment in companies with less than $100 million in assets.

What we lost by this kind of concentration? To begin with, the withdrawal of pension investment from companies in the growth band of the economy also discourages mutual funds and other investors from buying the stock of promising young companies. This breaks the chain of investment which is necessary to finance early stages of business growth.

This in turn has compounded the problems of the brightest and best of the new and small businesses, which traditionally have been the source of over half the Nation's inventions and innovations.

Two years ago, our committee heard the story of Mostek Industries, a company founded in 1969 with $5 million in venture capital to produce large-scale integrated circuits by a new process. This single company has made the United States the center of the watch manufacturing industry and has become the foundation for U.S. leadership in the worldwide $7 billion semiconductor industry.

In 1969, there were 548 smaller companies with under $5 million in assets which were able to sell registered securities issues to the public. In 1975, there were literally a handful, three or four.

An MIT study found that, between 1969 and 1974, five young technology companies—Data General, Compugraphic, National Semi-Conductor, Digital Equipment and Marion Laboratories—created 34,359 jobs. This was one-third more new jobs than the sample of six giant corporations which ranged 9th, 17th, 26th, 32d, 38th, and 78th on the Fortune 500's most recent asset list—General Electric, du Pont, Bethlehem Steel, Proctor & Gamble, and International Paper.

The testimony at our May and June hearings has been that ERISA has virtually placed pension capital off limits to the most inventive, resourceful, and competitive segment of the economy—smaller business—and is therefore a major factor in suffocating small business growth, job creation, and progress. These are determinative factors in the future strength of our economy and the ultimate real income value of the monthly retirement check.

Therefore, the object of this hearing is to search for changes in the prudent man rule to again make possible pension investments which will nurture small business innovation and progress in the economy. We seek to do this in a way which will enhance rather than jeopardize the rights of retirees, and will not open the door to abuse.

The committee is grateful to the witnesses who have devoted their time and effort to assist us in this important area.

Our first witness this morning will be Mr. Harold E. Bigler, Jr., vice president, Connecticut General Life Insurance Co., Hartford, Conn.

I am very pleased to welcome you here this morning. We appreciate your taking the time to come and testify.

Your statement will be printed in full in the record, and you may present it however you desire.

STATEMENT OF HAROLD E. BIGLER, JR., VICE PRESIDENT, CONNECTICUT GENERAL LIFE INSURANCE CO., HARTFORD, CONN.

Mr. BIGLER. Thank you, Senator.

I am Harold E. Bigler, Jr., vice president of Connecticut General Life Insurance Co., Hartford, Conn. I am also president of an affiliated company—CG Investment Management Co. Between the two organizations we have total assets in excess of $10 billion. I have also been a member of the investment committee of Brown University for 12 years, and for several years was a member of the investment advisory council of the State of Connecticut, resigning last fall as chairman. This latter body oversees the investment of some $800 million of State pension funds.

I am not appearing today representing any particular point of view, but I point out my various affiliations and duties, and would also comment I am this very day beginning my 21st year in the investment business to establish my credentials. I consider myself a pragmatic investor with broad experience and background in managing other people's money ranging from conservative funds to aggressive portfolios, including venture capital.

My remarks this morning will be brief in the hope that any questions you raise will draw the issues which concern you into focus, and I can direct my attention specifically to them. I would be happy to expand, in writing, on my points for the record at a later date.

My comments are directed to one phrase from the proposed amendment to section 11—"the prudence requirement of paragraph (1)(B) is not violated solely because an investment may be in a venture capital organization or in a smaller business."

Much has been written and several groups have examined and researched the current state of funds for venture capital and small business investments. The conclusions are generally unanimous—such funds are not broadly available. The venture business, as we knew it through 1973, no longer exists. Those pools of money which have been available in the past couple of years have been directed primarily toward the acquisition of existing ongoing businesses and not toward the formation of any new enterprises.

Why are we in this state?

Well, the whole Nation is in a risk-avoidance mode. From industry, to the largest financial institution, to the individual, no one is willing to think very far into the future and certainly unwilling to put assets on the line for other than an almost assured return. We can see this in the New York Stock Exchange—a proxy for the mature business enterprise. Price-earnings ratios have come down across the board, and the spread from highest to lowest is as narrow as I can ever recall. The investment community is unwilling to invest in the future.

We are paying the price for inflation, but this is not the forum to debate the causes of that. Not only are investors unwilling to buy futures, but businesses as well, and the reasons are the same—inflation, unknown tax and regulatory policy, energy, and a whole host of other uncertainties. The businessman does not know how to discount his investment in new plants and equipment, for example. And certainly if any exposure is large, that is, a greenfield plant costing several hundred million dollars, such needs are postponed or plans scrapped entirely. Thus, we now find, and I believe will continue to find, an increase in tender offers. It is cheaper to buy someone else's plant rather than build one of your own. This phenomenon does nothing except to assure that the strong will be stronger and that we will continue to have difficulties in expanding this Nation's productive capacities, in dealing with our high unemployment rate, and in raising capital for smaller enterprises.

I believe that the phrase I referred to in S. 1745 can do no harm and might, in time, do some good. It will not, in my opinion, encourage the flow of pension funds into high risk equity investments in the present environment. Until reasonable and more historic rates of return have actually been experienced in traditional equity portfolios there will be little capital flowing into high risk investments.

There is a broadening of the stock market occurring at the present time. The relatively positive performance of the Value Line Index versus the Dow Jones or the S. & P. 500 indexes indicates that smaller capitalization companies are once again receiving investor recognition. While moneys are flowing into small capitalizations, sufficient sums are still not flowing into that sector of the OTC market which would eventually encourage the new issue market to return to its former active levels. As prices for many over-the-counter stocks have risen, it must be remembered that prices can often rise substantially without much capital changing hands. Remember that the entire capitalization of a company is valued as a result of the last 100 shares traded on any given day. Thus, the improvement may be more perceived than real.

A healthy new issue environment is a necessity if the recycling process of venture capital funds is to be concluded. An outlet for investments in private companies is essential if the process is to be repeated. When I first became active in the venture capital field in the late 1960's, the rule of thumb was that you should seek your return on capital within 3 years; thus giving the investor the opportunity to rollover assets into one or more additional venture capital opportunities. In recent years, that period has stretched to 7 or 8 years, if indeed it is possible to realize a gain at all.

A word of warning. There is not enough experienced investment talent in this country to handle a large inflow of venture capital in the classic sense of the term. I am sure we all remember what happened to certain industries when too much money was made available without enough legitimate and experienced personnel to handle it, for example, mutual funds in the late 1960's and the real estate investment trusts in the early 1970's, and venture capital itself in the late 1960's and early 1970's. This is one of the reasons I would be opposed to specific guidelines for the allocation of funds—particularly venture funds. Venture, in my opinion, should be an equityholder's risk. This means funds should be provided by individuals or shareholders rather than creditors or policyholders of financial institutions.

One of the problems that I see creating difficulties in overcoming the risk avoidance mode I referred to previously is the attitude and experience of current day investment staffs. In the 1960's our more senior and experienced associates used to remind us that "the problem with you younger people is you have never been through a bear market." Today, we can say to our younger associates "the problem with you is that you have never been through a bull market." Too many investors avoid risk rather than determining how to be paid for taking risk.

The difficult environment for equity investing for almost 12 years has taken its toll and it will be hard for many equity investors to reestablish credibility. I can imagine the conversation with a client or board of directors by an investment manager suggesting the entry into venture capital investing in light of generally negative equity results for the past 10 or 12 years for the traditional portfolio.

Economic stability is necessary to set a proper environment for risk taking. This would mean declining inflation and stable and real growth in the private sector. You people in Washington may have a better feel for the probability of that occurring. From where I sit up in the hills of Connecticut I have to take a "show me" attitude.

I would close with a couple of suggestions; some of which I recognize are beyond the purview of this committee. There are tremendous product development opportunities within present business enterprises. I am certain that many large corporations have within them products and profit opportunity which are not being realized because the opportunities are either too small relative to the size of the organization or the product does not fit with the corporate or divisional strategy. Some incentive for such organizations to spawn new businesses could do a great deal to develop companies with future potential for creating jobs and the introduction of new products into our economy, with an above-average chance for success.

The regulation of business in this country makes it very difficult for small organizations to grow. Mandated capital expenditures alone are deterrents to growth. I am thinking of OSHA, pollution control, energy conversion, and so forth, and so forth. Some years ago we attempted to breathe life into a struggling publicly held enterprise which had been a venture capital investment of ours, and as part of our investing process found that this company was barely being kept alive, but with long-term potential, had costs approaching $100,000 per year simply because the company was publicly owned.

If the financing of small business is to be made attractive and the funds encouraged to go in that direction, something must be done with our tax laws. If one is going to take high risk with investment dollars, he must see a potential for high returns on an after-tax basis and we all know the direction our tax laws seems to be going. They discourage risk taking. I would submit there is nothing wrong with an individual making a great deal of money if it is done on a creative, legitimate basis.

Senator NELSON. As you are aware, the administration is talking about tax revision. It was your testimony that something should be done with the tax laws—what would you consider the most important change in the tax laws for encouraging investment in smaller business?

Mr. BIGLER. I think perhaps my next sentence might touch that as well. But basically I think as we are erroding capital gains treatment, we will lose the incentive on an aftertax basis to take risks. I throw out for the record at least the thought that exempting capital gains which are realized within so many years of a new business formation from taxation would be the type of incentive that I think might attract capital into small business in the high-risk spectrum of investing.

Senator NELSON. As I understand it, the administration is discussing the concept of simply setting a maximum tax rate of 50 percent which would include capital gains.

Mr. BIGLER. It would include them; yes, sir.

Senator NELSON. That is not what you are talking about.

Mr. BIGLER. That is not what I am talking about.

Senator NELSON. You are talking about some recognition in the tax structure of capital gains on the somewhat longer term. You are not talking about the period recognized by the current law—6 months or 12 months.

Mr. BIGLER. That is correct. Some longer term and for funds put into new ventures. Perhaps a treatment similar to that that you would have as a homeowner. You could sell your home and you would have so much time to roll it over into a new investment. I think you could perhaps follow this same treatment.

Think of an individual putting up $1 million into a venture-type organization. If he doubles his money, depending on the number of years and so forth, but assume it is a 10-year basis—realizes the gain, pays the tax at a 50-percent rate—it has hardly been worthwhile for that individual on a total rate of return basis after taxes to risk $1 million.

Senator NELSON. At least in these kind of inflationary times——

Mr. BIGLER. Yes; of course, but I think with bonds at 8 percent, you get my point.

There is one other thought I would leave with you, and this involves the ability to sell stocks without additional registration.

We have the best secondary equity markets in the world, but they are handicapped for primary equity raising by involved regulation and redundant reporting requirements which discourage new equity offerings for smaller organizations which are costly to business and to government.

To encourage greater use of external equity sources, why not permit companies which are otherwise registered with the SEC and which have met all regulatory and filing requirements on a timely basis, to sell small amounts of equity—say, up to one-half of 1 percent per month of outstanding shares—on the open market without registration? Increasing use of such external equity sources would lead to greater financial stability, increased entry into profitable business, greater competition, and a greater ability to take risks.

I would be happy to answer any questions.

Senator NELSON. Your suggestion of allowing a company to sell small amounts of equity—up to one-half to 1 percent per month of outstanding shares without registration—what does that actually mean? The stock is already registered.

Mr. BIGLER. The stock is already registered. The company is current on all its filings. The public is informed as to the operations of that company, its financial status, and so forth. It just has the ability to call its broker, if you will, and sell shares directly to the public at the last sale for a minor amount. Over a period of time 5 or 6 percent a year of the outstanding capitalization could be made available for additional funds.

Senator NELSON. Not knowing enough about the flotation requirements, the paperwork, the legal fees, the time factor, what advantage would your recommendation provide the company?

Mr. BIGLER. Well, the alternative to that would be the registered offering. There, aside from the legal fees which could be substantial, and the dealer's concession, the cost to the company might run for a small corporation up to 7 to 10 percent of the amount being raised.

Senator NELSON. Just the paperwork of going through the registration procedures may cost them up to 7 percent of the total amount of capital that they would be getting from the sell, is that right?

Mr. BIGLER. That is correct, plus the amount they would have to pay the distributing organization—the investment banker and the broker selling the shares.

Senator NELSON. You mean in addition to that there would be the broker's commissions?

Mr. BIGLER. No, no; that would be included in the 7 to 10 percent; yes, sir.

Senator NELSON. Under the suggestion you are making, the small company simply could sell a limited amount of one-half to 1 percent per month without going through that registration procedure.

Mr. BIGLER. That is correct. They would dribble it in, if you will.

Senator NELSON. What arguments might the SEC or anybody else make against that? What weaknesses, if any, is there in that?

Mr. BIGLER. I suppose that SEC could say that the public is not being protected through disclosure, but I would suggest that if the company were required to make a statement at the beginning of the year or the beginning of the quarter, that it intended to take advantage of this rule, then investors would be fully informed that there would be dilution to the tune of x percent that quarter, 2 or 3 percent that quarter of the year. I do not think the public would be harmed. It is hard for me as a professional investor to see where harm would be done.

Obviously, there is a certain amount of overkill in protecting the world against the rascals that are out there. There are rascals in our business as there are in yours. Someone will always find ways to take advantage of anything. But I would submit that the advantage to small business—small and medium size businesses—in being able to approach the market directly, if they are already complying with every other regulation, would be tremendous.

Senator NELSON. Is there any advantage to large business?

Mr. BIGLER. I am not sure it would be an advantage. It would not do them any harm. It would certainly permit IBM to dribble stock into the market. Although I read in the paper this morning—they are more apt to acquire their own rather than sell new. But, yes, the same principle could apply or if the public policy came to the conclusion that this was an advantage that small business should have. I would submit that small business in this day and age deserves some advantage. Perhaps you put a cutoff at a certain capitalization size.

Senator NELSON. Well then, for purposes of this proposed change in the law, how would you define a small business?

Mr. BIGLER. I would define a small business certainly under—I think in terms of capitalization market value—number of shares outstanding times the price of the company—certainly under $50 million and perhaps under $25 million which in professional investor terms is a very small company. And $25 million seems like a great deal of money, but in terms of publicly held corporations it is quite small.

Senator NELSON. You are talking about total assets of $25 million?

Mr. BIGLER. I am talking about net worth—you could have a net worth test or an equity capitalization test.

Senator NELSON. I realize all companies differ in the different amount of sales, but what size company are you talking about in terms of annual sales?

Mr. BIGLER. Naturally, it would depend upon the type of business it is in, but probably $10 to $25 million in sales. I would say up to $25 million.

Senator NELSON. I think that is a very interesting suggestion and might very well be very helpful to small enterprises.

Mr. BIGLER. Well, I have struggled, sir, with our own portfolio venture capital companies, many of which are public today, but the problems they have in raising additional funds, even though they have perhaps some large financial institutions as backers—there comes a point when even those institutions are unwilling to put more money into an organization, and these are legitimate, reasonably well run, profitable enterprises. But they just cannot get to the sources of additional capital.

Senator NELSON. I am a member of the Finance Committee, as you know at this point, it is uncertain when the administration may propose some comprehensive tax revision. They have been discussing individual proposals with members of the Finance Committee as of now. At the very most I would expect that the administration might make a proposal this year and there might be some hearings, but there certainly will not be any legislative action. That would have to come next year.

I am wondering if it would be too much of an imposition if you might furnish us a piece of paper as to how you envision your suggestion would work—the advantages of it, the size company you would suggest, the reason for it, and whatever criticisms you think might be raised. I think it might be a very valuable paper to have in hand at the time the Finance Committee gets around to dealing with tax revision.

This committee has done quite a bit of work on the last tax revision or "tax reform" legislation—trying to tackle the question of assisting small business in terms of corporate rates (increasing the surtax exemption) and the estate and gift tax provisions. It would be very helpful if, based upon your lengthy experience, you could give us a page or two or three whatever is necessary to make the case.

Mr. BIGLER. I would be happy to do that.

Senator NELSON. Thank you very much for taking the time to come testify.

We may have some additional questions. I would assume we could send them to you and you would be willing to answer them for the record.

Mr. BIGLER. Sure. I would be delighted.

Senator NELSON. Thank you very much, Mr. Bigler. We appreciate your testimony this morning.

[The following was subsequently supplied for the record:]

A PROPOSAL TO INCREASE FLEXIBILITY OF EQUITY AS A SOURCE OF GROWTH CAPITAL FOR THE ECONOMY

(By Edward Guay, Chief Economist, Connecticut General Life Insurance Co.)

BACKGROUND

Although the United States has the best secondary equity markets in the world, they are handicapped for primary equity raising by involved regulation and redundant reporting requirements which discourage new equity offerings for companies of all sizes, but particularly, for small businesses.

The Securities and Exchange Commission has made changes in its regulations in recent years to reduce the duplication between annual and quarterly disclosure filings and offering disclosures. Reform of Forms S-7, S-8, and S-16 has reduced to some extent the costly duplication which is a disincentive to equity offerings. Regulation A (Section 3b) offerings have also been used in recent years (240 filings in fiscal 1976 with a median value of approximately $300,000 each).

But the regulatory process continues to cause the raising of risk capital (equity) to be far more difficult than raising bank loans, the issuance of commercial paper, or the issuance of other senior fixed obligations. The regulation of new issues still gives inadquate recognition to the significant increase in routine disclosure requirements since the Securities Act of 1933 was passed.

Significant advantages are to be gained for the economy and particularly for smaller businesses by reducing the restrictions on new equity offerings. Among the benefits to be gained by easing registration requirements are lower distribution and total capital costs, greater financial market stability, and more efficient transfer of capital from declining to growing companies. More flexible use of equity financing can encourage increased competition and more rapid product and process innovation by freeing well managed companies from the constraint of relying on debt or internally generated funds to support growth.

Increased use of equity in capital structures permits greater flexibility of management, greater independence from lenders, and more rapid adjustment to change. Greater access to the equity markets can permit business managers to smoothly manage capital changes and leverage, to fund expansion projects with equity either as expenditures are made or to repay borrowings related to expansions, and, in the case of regulated industries, to meet minimum capital requirements in an orderly way. Greater use of equity throughout the business community can reduce the incidence or the severity of the financial crises which we have experienced three times in the past eleven years.

Finally, for the economy, in addition to greater competition and innovation, easier access to the equity markets to raise new capital can offset the negative effects on internal capital formation of shareholder demands for larger and more stable dividends, can ease the cyclical transition from consumer-led to business-investment-led economic expansion, can permit faster recoveries from the recessions which do occur, and can permit above average real growth during periods of disflationary monetary policy such as the present.

The abve can be done without harming the effectiveness of the SEC as an investor protection agency. It can be done in such a way that greater resources become available within the Commission for more meaningful disclosure and enforcement.

PROPOSAL

To encourage greater use of external equity sources, it is proposed that companies which are otherwise registered with the Securities and Exchange Commission and which have met all regulatory and filing requirements on a timely basis during the prior year be permitted to sell through broker members of the National Association of Securities Dealers or broker members of the regulated exchange an amount of new shares each month not to exceed ½ of 1 percent of shares outstanding at the beginning of the month. Such shares would be sold through a routine broker transaction and could be sold on any business day or combination of business days during the month. The right to sell shares would be non-cumulative from month-to-month. The shares issued under this proposal would be subject to automatic registration.

Before any company could use this procedure for the first time it would be required to give public notice and simple formal notice to the Securities and Exchange Commission at least 90 days before an eligibility date. During the 90-day period the SEC may review the disclosure documents of the company (prior registration, 10-K, 10-Q, etc.) for consistency with generally accepted standards. If during such review the SEC determines that the company is ineligible because it has failed to meet filing requirements or to meet them on a timely basis during the past year it will so notify the company. If the SEC staff determines that the company disclosure is not consistent with generally accepted standards, the SEC staff may either negotiate additional disclosure by the company, in which case the company becomes eligible for automatic registration of equity sales 30 days after the filing of the supplemental disclosure, or the SEC may schedule a public hearing to disqualify the company from eligibility. Notice of public hearing must be made within 90 days of the first notification to the SEC by the company. The public hearing must be scheduled within 180 days of the first notice by the company and a company may be ruled ineligible if the SEC finds that routine disclosure by the company does not meet generally accepted standards for a company of its size and of its industry. If the SEC rules that a company is ineligible, it may file a new first notice after correcting deficiencies in its disclosure.

If the SEC takes no action during the 90 days after a company files its first notice, it becomes eligible for sales by automatic registration on the ninety-first day. The company must give public notice of its eligibility, but then may proceed. The public notice should identify the company, declare the eligibility, state that the company may from time to time sell shares in the open market, and indicate the maximum number of shares that the company may consider offering during the coming year by means of automatic registration (not to exceed ½ of 1 percent of outstanding shares per month).

Within thirty days after the end of each calendar quarter in which a company uses automatic registration procedures to raise capital it must file a one-page form letter with the SEC. The form letter would include:

1. The legal name, legal address, and telephone number of the corporation.
2. The principal contact officer of the corporation with respect to equity sales.
3. The number of shares outstanding at the beginning of the previous quarter.
4. The number of shares sold during the previous quarter, by month, under this automatic registration procedure.
5. Registered shares issued by other means (formal registered distribution, registered conversions, or registered combination).
6. Total registered shares outstanding at the end of the quarter.
7. Reference to the most recent 10-K and 10-Q (or equivalent) reports by period ending, filing date, and company reference number.

The public protection goal of the Securities Act can be met by the following provisions:

1. The companys right to sell shares under this provision is immediately and automatically suspended if it fails to meet filing dates for 10-K or 10-Q reports (or their equivalents). In the event of such suspension, the company must follow the procedure of "first notice" to restore eligibility.
2. Automatic registration sales may not be made during a trading halt ordered by a regulated exchange, the NASD, or by the SEC.
3. Automatic registration sales may not be directly placed and must be market or limit orders placed through a broker/dealer as agent.
4. The SEC, a listing exchange, or the NASD may request a halt to sales under automatic registration for up to fifteen trading days if they believe that such time is necessary to properly disseminate news relating to a major development which may affect the company.
5. The SEC may order a halt to sales under automatic registration procedures for renewable 15-day periods under fraud provisions of the securities laws.

While this proposal enhances and strengthens the disclosure function of the SEC, those charged with the registration function are likely complainants. When the Securities Act was first passed disclosure was minimal or non-existant. As a result, the Act provided that disclosure be made before new securities were sold. Now, routine disclosure is overwhelming and the disclosure requirements specific to registration are often redundant, burdensome, and unnecessarily costly.

The investment banking community is also likely to be a complainant. Although an increased volume of equity offerings is likely under this proposal and the greater volume would generate brokerage and exchange revenues, for investment banking firms which emphasize underwriting rather than brokerage, this proposal would produce a net loss of revenue (to the benefit of the stock issuing companies.

The legal firms which rely on fees collected as part of the cumbersome registration process would also be complainants under this provision since there would be a substantial reduction in the need for their services.

Banking firms should have mixed feelings toward this proposal. It benefits them in capital raising; they can more smoothly match the growth of risk or earning assets and capital. It also allows them to develop more innovative financing arrangements for small and medium size corporations. An example of this would be an expansion or project loan which is funded gradually after the completion of the project with equity sales by the borrower. But this provision also potentially makes the customers more independent of the banks.

Some shareholders may feel that they can too easily be diluted or that management is given too much flexibility by this proposal. However, the shareholders of each company can control the use of this provision by management through control of the number of authorized shares or by proxy resolutions which restrict the ability of management to use this provision in a manner which is undesirable to a majority of the shareholders. If a company is well managed, the shareholder benefits because a company can both pay a reasonable dividend, thus stabilizing the stock price, and continue to take advantage of growth opportunities as they develop. The management can also better plan and manage their finances for all possible cyclical or growth alternatives.

In summary, there will be some complaints about the proposal but the benefits far outweigh the possible problems. Those benefits include but are not limited to:

1. Lower cost of raising capital.
2. Greater financial stability.
3. Greater risk-taking and innovation.
4. Increased competition.

5. Faster employment growth by innovative companies.

6. Possible improvement in regulatory influence over financial soundness in banking, utilities, and other financial industries.

7. Better financial planning and structuring of equity relative to debt in business.

8. A sound and practical offset to current pressures for more reasonable dividend payments and a good supplement to proposals for dividend tax integration which may have a tendency to reduce retained earnings as a source of capital formation and growth.

Although this proposal solves only part of the long-term capital formation problem (other parts include the problems associated with inflation and depreciation, the availability of fixed rate long-term loans for small business, double taxation of dividends, and the availability of high risk venture capital), it can make a significant contribution to orderly capital formation. Because it can make such a significant contribution to meeting the capital needs of energy, modernization, competition, and employment growth, it should not be limited to small businesses but should be generally available to all registered corporations. Although it could be extended to all registered companies, the smallest companies would obtain the greatest proportional benefit because they suffer from the largest underwriting and distribution costs and this proposal would give them a degree of financial flexibility which they do not now have, not just in raising equity, but, also, in dealing with current and potential lenders.

Senator NELSON. Our next witness is Mr. Robert J. Hickey, attorney, Washington, D.C.

Your statement, Mr. Hickey, will be printed in full in the record. You may present it however you desire.

STATEMENT OF ROBERT J. HICKEY, ATTORNEY, WASHINGTON, D.C.

Mr. HICKEY. First, I want to thank the committee for permitting me to testify.

I have been in the pension field since 1964 when I first wrote an article on the developments in the pension field. I say that because at that time when I wrote the article, I had the most difficult time trying to find anything about how it related to labor problems and fiduciaries. It was a very, very small field with very few cases. In fact, I used to get calls in regard to the article I wrote as though it was a panacea, which by any stretch of the imagination it was not.

From that point on—1964—I followed the field very religiously.

I have taught a course at Georgetown University, and at one point I was an editor of a service on employee benefit plans.

I give this as a way of a background because I am hoping that my testimony will present to the committee how the law of pensions has developed, so that it can understand what in fact will happen under the various proposals.

I would like to just summarize my statement and then let the Senator ask any questions he believes relevant.

The basic requirement here in regard to fiduciaries and the prudent man rule comes from the section 404(a)(1). The section itself is very general. It talks about the obligations of the fiduciary to discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries. This is very important because it does say what the whole purpose of this law really is in very succinct language. It is to protect the interests of the participants and the beneficiaries. The remaining section of the same section 404 talks about various ways this can be done. One section says that it has to be done in a prudent manner and defines what constitutes prudent. Another section says that the investments have to be diversified.

Now, I want to point out from a lawyer's viewpoint that the two sections are not the same. In other words, diversification of investment is not given as an example of prudent man rule. It is put forth as a separate distinct requirement.

Having said that—then the question is—what do the two mean?

Well, they mean different things and they are somewhat in conflict. Prudence is a very simple concept, although I assume if you could read law reviews and if you heard testimony here, you would say it is a very complex concept.

But in itself all it means is that you take care in the handling of the property and money belonging to others. By itself that does not impose a very horrendous obligation. But what does it mean when you are talking about investments? The question on all investments is the same—one of risk.

Today, there is no such thing as no-risk investment. So the question facing the committee, as facing a fiduciary, is the same—what is an acceptable level of risk?

Now, over the years this has varied from company to company, fiduciary to fiduciary, but I think we can say today that one of the prime factors and some say the prime factor, is the question of liquidity. I think people focus on that. You look at Penn Central or at most of the major companies that have gone bankrupt in recent years. It has not been for the lack of assets but for the failure of having liquidity.

With this as a standard or the prime standard—applying the principle to a small business—it becomes very evident under the prudent man rule that investment in a small company would involve more risk would be less prudent than an investment in a larger company. If we have fewer investments in small companies, we will have fewer growth companies.

The concept of prudence and the elimination of small companies from acceptable investments is reflected in most State legal lists that were devised as investment guides for trustee holdings. In all of them you will note the absence of small companies or even the mention of small companies.

So if we focus solely on the question of the prudent man section in the act, we would have to come to a conclusion as an attorney that an investment in a small company would be imprudent under the present state of the law.

Senator NELSON. You mean as the law was changed in the ERISA Act or under the law prior to that?

Mr. HICKEY. A little bit of both. The problem here in regard to the prudent man rule is that it has developed somewhat differently than most people think or have thought about. The original concept of prudence goes back to early English law. Some of the people in the room who have had courses on trusts would understand the little quasi-French phrases that they referred to in the trust field. What they were really talking about was that if you had some money and you wanted to protect this money for your wife and children after your death. Basically it was a very simple thing. You were really concerned about preventing the wasting of assets, not so much in terms of an investment, for example, making money off those assets. The concept was a very conservative approach to property.

At this point there was a major change in the law as a result of a case called *Harvard College* v. *Amory*. For the first time an investment was sanctioned. Prior to that time any investment would have been very questionable from the viewpoint of prudence because of the risk involved. With the *Harvard* decision the concept was one that you could invest in very secure stocks having a minimal amount of risk. This is the way the law of prudence developed.

But starting with the development of employee benefit plans—the law in regard to them has not followed that concept. The old language is quoted and the opinions appear to be same, but if you look at the investments that have been approved, you see a greater diversification in investments. In the prepared statement I give an example of a loan to an employee as being held to be a prudent investment. Now that obviously would not have been a prudent investment if you were protecting an individual's estate. So as to employee benefit plans, there was diversification. There was more liberalization in regard to investments by employee benefit plans.

The problem in this field has been of course that there has been very little in the way of collection of cases that lawyers and judges can refer to regarding how the law is developing. As a result, they tended to look at the development of trusts in the State law and give lipservice, but in fact were being much more liberal. But even under that standard or even under the standard that has developed in regard to employee benefit plans, at the time ERISA was passed, probably I would have said that an investment at that time in a small business would have been imprudent.

If ERISA had not been passed, I would venture to say in time an investment in a solid small business would have been upheld. The trend in the law definitely was toward liberalization in regard to employee benefits plans. They were being treated separately. The courts were recognizing that they were somewhat different than somebody's estate, and that was the trend. But if you took it just at the point in time ERISA was passed you might have gotten a court or even a couple of courts to agree with investments in a small company, but from a lawyer's viewpoint advising a client, you would have had to tell them that the risk was too great for him to take to get involved in a lawsuit.

Senator NELSON. You are saying that the language of the ERISA Act reversed that trend?

Mr. HICKEY. I think so.

Senator NELSON. Precisely why do you think that?

Mr. HICKEY. Well, the basis is not in the language of ERISA but on the history of trusts leading to the development of the act. What you have here is a reaction by Congress to horror stories of persons unable to collect pensions after years of service. Any time you have a reaction set in, people are going to be scared. They see the horror stories. Someone mentioned they are having hearings today on the Teamster's Central State Pension Fund, which I assume would be a can of worms on every single investment.

These were the things that people were focusing on and were trying to correct. They were not thinking in terms of what the effect those restrictions might have on individual types of investment, certainly in regard to small businesses. They were completely overlooked. The hearings were focused on companies like A. & P.—major companies—

very little in the hearings would give any indication that anyone was considering the impact of the act on small businesses.

Senator NELSON. But was there any specific language that caused that, or was it just the tone of the language of the whole legislation?

Mr. HICKEY. Well, it is both the tone and specific language. As I go on to say in the statement, the real problem in this act is not so much in regard to the fiduciary section, but in regard to the civil suit section. The civil suit section—well, if you start at section 409 which makes an individual fiduciary liable for his own assets. That is the first item. Then he can be sued under section 502. But the real horror is that attorney fees can be awarded against him.

Now, take this example, you come to me and you say to me, Mr. Hickey, I would like to invest in a small company. I look through all the legal lists and I see that the company is not listed. I tell you, there is a risk involved. And you say, well, I still think ABC small company is a good investment. I reply, that is great, but what if someone challenges you and takes you into court. Now, you are going to have to pay your own attorney fees and you might have to pay the attorney fees of the other side in addition to the cost of having experts come in to testify as to what is and what is not a good investment. Most of the cases involve hindsight. People, I assume, invest with the idea that the investment is going to be good. It is only after when it goes bad that everyone comes in and complains. So you're talking about a suit that could run anywhere from $10,000 to $40,000 a year in your own attorney's fees, and might very well run up to $80,000 overall if you are the loser for that year. If a case goes on 3 or 4 years, you are talking in terms of $300,000 to $400,000 in legal fees. It is up to the individual to come up with the money himself.

Senator NELSON. Are you talking about the individual or the board of directors of the institution that does the investing?

Mr. HICKEY. The individual fiduciary under this act is individually liable. The board itself, if it goes along with the individual fiduciary, will also be liable. But you are talking about coming to me and making the decision, and the money is going to come out of your pocket. And I have to say to you as I would any client that it is not worth the risk. That is exactly the problem with the present statute. It does not make a difference what we say is a good investment or not a good investment—the question is how do you prevent somebody from being sued over his judgment.

Senator NELSON. A survey that was conducted by the International Foundation of Employee Benefit Plans at regional seminars on ERISA in July in New York, Chicago, and San Francisco, has come to our attention. A story in a pension publication states that the survey also found that of the 264 respondents, more than 75 percent felt that it is more important than ever to use the services of an outside firm to measure or assess their funds investment performance. But on the question, question 9 in the survey, "as a result of ERISA our trustees are less willing to invest in anything other than blue chip type investments," the results were as follows: Strongly agree—26 percent. Agree somewhat—38 percent. Disagree somewhat—16 percent. Disagree strongly—8 percent. No answer, not sure—12 percent. So you end up with 26 and 38 percent, or a total of 64 percent agreeing somewhat or strongly agreeing with that statement.

[The material referred to follows:]

ERISA DRIVES PENSION PROS TO BUY BLUE CHIPS

BROOKFIELD, WIS.—About 90 percent of pension fund and employee benefit officials responding to a rceent opinion survey feel that ERSIA has greatly increased their personal liability exposure for investment decisions.

This finding may explain why more than 60 percent of these respondents—trustees, administrators, attorneys, actuaries, consultants, and investment counselors—state that as a result of ERISA, they are less willing to invest in anything but "blue chip" and fixed income securities.

These are some of the results of a survey conducted by the International Foundation of Employee Benefit Plans at regional seminars on ERISA in July in New York, Chicago and San Francisco.

The survey also found that of the 264 respondents, more than 75 percent felt that it is more important than ever to use the services of an outside firm to measure and assess their funds' investment performance.

Another significant result of the survey revealed that 58 percent of these officials would prefer if the return on investment exceeds the actuarial interest rate assumption, rather than simply breaking even with it.

This survey, part of the foundation's on-going research program aimed at determining the impact of ERISA on Taft-Hartley benefit plan operations, also revealed the following:

Trustees feel they can no longer invest fund assets to finance community-type projects or to promote employment for plan members if other investments would bring higher yields or involve less risk.

More than half of the respondents find it is getting harder to get management representatives to serve as trustees on plans having equal union-management representation. No similar problem seems to exist on the union side.

More than 50 percent of the trustees see little interest in real estate investments as a result of ERISA's diversification requirement.

The survey results are shown in the accompanying table.

SUMMARY OF RESPONSES[1]

[In percent]

Subject statement	Percent of responses for each answer category: Agree strongly	Agree somewhat	Disagree somewhat	Disagree strongly	No answer, not sure
1. ERISA has greatly increased the personal liability exposure of trustees for investment decisions	57	32	7	2	2
2. Due in part of ERISA, it is increasingly difficult to find union representatives to serve as trustees	6	22	26	28	18
3. ERISA's diversification requirement has significantly increased our fund's interest in real estate investments	2	13	22	34	29
4. ERISA's "Prudent Man Rule" is too vague to be very helpful in making investment decisions	16	37	23	18	6
5. Trustees should take a more active intrest in the management of the companies in which they invest fund assets, including the exercise of stock voting power	19	25	16	31	9
6. Due in large part to ERISA, it is increasingly difficult to find management representatives to serve as trustees	23	35	16	13	13
7. The diversification requirement of ERISA has significantly increased our find's interest in index funds	5	13	17	19	46
8. ERISA makes it more important than ever to utilize the services of an outside firm to measure and assess our fund's investment performance	46	31	12	6	6
9. As a result of ERISA, our trustees are less willing in anything other than "blue chip" type investments	28	38	16	8	12
10. In the future our trustees will be satisfied if the return on investments simply meets rather than exceeds the actuarial interest rate assumption	7	24	27	31	11
11. Due to ERISA, trustees can no longer invest fund assets to finance community-type projects (like a hospital) or to promote employment for fund members if other types of investments would produce higher yields or involve less risk	30	22	17	6	25
12. ERISA's diversification requirement has significantly increased our fund's interest in "guaranteed" return contracts offered by major insurance carriers	21	28	16	13	22

[1] Courtesy of the International Foundation of Employe Benefits.

Senator NELSON. Is that your experience in dealing with the investors?

Mr. HICKEY. I think what that statement says is correct, but we are going one step further. We are talking about a small business. If the question was put in terms of a small business, I think you would have had near uniformity, particularly those that had attorneys advising them not to do it. You would have to advise a client that the risk is too great.

Now, what has happened here is the fact that you might have been willing to take the risk, but you have no insurance that adequately protects you. There is no insurance being sold in the United States that would protect against the kinds of problems that are coming up or will come up under ERISA. There is a problem regarding the attorney's fees as you go along. In other words, even if you can get insurance that would give you the attorney's fees, and as I said, I do not think that there is an insurance program in existence that does that, but even if there were that would do you little good if every year you are paying out $10,000 to $40,000 to defend a case. You are talking about the average trustee. Now where is he going to get this money. He is going to have to mortgage his home—for what. When you can just tell him to forget about it. There is no problem.

We can take a blue chip or we can take something from the legal list. It might not give you a good investment. It might not do a lot of good insofar as social goals being attained, but there is no risk to you personally. That has to be the bottom line in your advising either an individual or a firm. You are being paid to advise them to prevent losses. That is a problem with the law. It is a problem with some of the concepts behind the changes in the law, that people are not willing to accept the fact that it does little good to come out with a piece of legislation that says we will encourage investments in small businesses if in fact it does not have protection against lawsuits built in. Because if it does not have it, my advice and the advice I would think of any prudent counsel would be—do not do it. You cannot afford to get involved in a suit just to test legal theory.

Going on—some of this we just covered. We do conflict the question of prudence with that of diversification. Diversification means simply just that—spreading risks among several companies. The purpose of diversification of course is simple from the viewpoint of investment, if one goes down you are not hurt absolutely. On the other hand there are the social goals behind diversity. One of course is undue concentration of wealth in big companies which leads to the monopolization of industries given in companies and of course will eliminate competition to a certain degree.

Another aspect of the problem of diversification is that if you cut off funds from small businesses you will encourage them to seek other sources of funds. One of those of course is obtaining money at illegal rates. The other is by having organized crime come in not only in the form of giving money but even controlling small business. Several months ago there was an article in the Wall Street Journal about the takeover of a milk company in Vermont—how slowly the same thing occurred. The company had borrowed money because it was a small company and slowly with each loan the organized crime got more and more involved until in fact they actually did control the company. That is not too unusual because of the fact if you were in organized crime you would try to diversify into small businesses. So the thing here you are not only preventing good social goals, but you are encouraging adverse social goals by not loaning money to small businesses.

Now, as I stated before, the purpose of all the legislation including the Senator's bill is to encourage loans, encourage investments in small businesses. This will not be obtained if individuals are exposed to suits.

Now, I wish I could come here with a panacea or even a suggestion of exact causes. Unfortunately that involves a lot in the way of what constitutes investments, good investments or any kind of investments. And I am not an investment attorney nor can I say I am very good at investments period.

I do think that we have to have at an absolute minimum a no-risk proposition. That means that if, whatever standard or formula we devise, comes out of this hearing, has to have in it absolute language both in the act and in the legislative history saying to the trustee of fiduciary, if you do this you will not be sued. Because if you do not have that in it, you can have everything else and you still will not get the investments you are seeking.

Senator NELSON. But in fact could you have such a provision? How would you design that? Would it permit a trustee who was grossly negligent in his investment to raise the defense is that it was a small business?

Mr. HICKEY. No; I think, again, it depends on two things. One, I think we should have in the legislation or as part of the legislation, maybe in rules, as much as you can define what we are talking about in regard to a small business. In other words the more we have in the way of definition, the more we have in the way of what constitutes a good investment. At least the trustee can say I have followed A, B, C, D, E, and F, and I should be home free at G. So the more you spell it out the better off you are. Again that involves, I think, testimony in regard to what is a prudent investment in regard to a small business. So we can build right into the statute or at least into regulations if you meet the criteria and you are home free.

Now, how do you prevent it, obviously, you cannot say, as you suggest, that you can do anything under the Sun. I think one way from a lawyer's viewpoint is what they call burden of proof. You put the burden of proof on the person who is attacking the investment. That would mean you have a great chance that if you can come into court and show that you have done that you could get a summary judgment. That still means that you have to spend some legal funds, but you at least would be able to cut off the litigation very quickly.

I think without those two criteria I think you would be open to lawsuits. You will never get away with lawsuits no matter how you think you will write a piece of legislation somebody will will sue you over it. But what you are trying to do is at least have some language in the act, some language in the legislative history as to what you are doing so that when you take a judge in any part of this country, no matter how unfamiliar he is with this act or investments generally, he can look at the investment and say its net criteria is A through D and, you, the plaintiff have come in here and you have not shown that it is otherwise improper. Therefore, we will dismiss the case with attorney's fees awarded against the plaintiff.

That is very important because again most class action legislation is really designed to encourage plaintiffs to sue, and I do not really think too much in terms of what the net effect is on the defendant. You might be able to spread the cost of litigation on the persons buying your product. But if you are a small company or a small firm, obviously you cannot spread that risk. So the thing here is to discourage as much as possible suits from being brought and from making it clear that if it does happen it can be decided very quickly.

Senator NELSON. Would it be possible for you to submit to us a two- or three-page description of what you think it ought to be?

Mr. HICKEY. In general terms, but I think in fact that I would have to work with somebody who had a better knowledge of investments. In other words, I would have to know the criteria for limiting the investment, but I could easily work with somebody or a member of the staff in devising that language.

Senator NELSON. However, you do believe that an investment expert could design a set of criteria which might include cash flow, debt, capital—a whole series of things—which if a knowledgeable investor found these standards were met as of the date of this investment, it would be a sound small business?

Mr. HICKEY. I think so. If they could not do it, the courts will do it, and they will do it in 10 or 15 years and probably in a very unsatisfactory way.

I think that is the substance of my testimony.

Of course, I am perfectly willing to answer any other questions the Senator might have.

Senator NELSON. If you could outline just your ideas at least on the law side for a page or two, the committee would appreciate it. We do not expect you to go to a great deal of work. We may then be able to get some investors, individuals or group, to further develop such criteria. It would be helpful to us.

Mr. HICKEY. I could do that.

[The following was subsequently supplied for the record:]

KIRLIN, CAMPBELL & KEATING,
Washington, D.C., September 9, 1977.

Re S. 285 and S. 1745.

SENATOR GAYLORD NELSON,
U.S. Senate, Select Committee on Small Business,
Washington, D.C.

DEAR SENATOR: I have given further thought to the language that would have to be included in a statute to limit liability. My view continues to be that the crux of the problem is not what constitutes a prudent small business investment. The Act would have to provide in simplistic general terms objective criteria to which a fiduciary could look in ascertaining the wisdom of an investment. Assuming that the language of the various bills could be so framed (and I believe that it can), I would recommend that, as part of the language, the following be included:

"A fiduciary will be deemed to have met the requirements of section 404(a) and related sections if the fiduciary makes a prudent small business investment as defined in Section   and in any challenge as to the prudence of such an investment the burden will be on the party attacking the prudence of the investment."

In addition to the above, I would further suggest that the language of the statute include within the same section the following section:

"In any action or proceeding under this section the court shall allow the prevailing defendant reasonable attorneys' fees as part of the costs."

I trust that the above language will be helpful to you in formulating a statute that would allow investments in small businesses.

Sincerely,

ROBERT J. HICKEY.

Senator NELSON. Thank you very much.

Mr. HICKEY. Thank you.

[The prepared statement of Mr. Hickey follows:]

STATEMENT OF ROBERT J. HICKEY, PARTNER OF KIRLIN, CAMPBELL & KEATING

My name is Robert J. Hickey. I am with the Washington-New York Law Firm of Kirlin, Campbell & Keating. I am a labor relations attorney and have been involved in the employee benefit field for 13 years. I represent both employers and employee benefit funds. I have taught, lectured and written in the field of pensions, particularly in regard to fiduciary obligations.

I am testifying here today in my capacity as a privtae attorney. I hope that my testimony will provide some insight to the Committee as to the practical decisions that must be faced by funds and employers in regard to investments.

The problem with the law presently is how to accommodate conflicting obligations on fiduciaries. The standard of protection is found in Section 404(a)(1) of Title I of the Employee Retirement Income Security Act. The basic obligation is that a fiduciary "shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries". There can be no difficulty with this standard. The question arises as to how he, in fact, shall act in discharging his duties. In anticipation of this question, the section goes on to state that the exercise shall be in a prudent manner and that the fiduciary shall diversify investments so as to minimize risks. These obligations of prudence and diversification can be in conflict.

Prudence requires that a fiduciary act with care in the handling of property and money belonging to others. How that care is exercised depends on both the plan's objectives and the beneficiaries' and participants' needs. In any decision involving investment there is always the question of risk. There is no investment that has no risk. The real question then becomes what is a reasonable level of risk beyond which a fiduciary should not go before he is acting imprudently. The focus always must be on the question of risk. Investments in larger companies usually incur less risks than those in smaller companies, particularly in modern day since major companies themselves are diversified. One of the major concerns, and some have stated it to be the major concern, is the question of liquidity.

A small company, and particularly a growing one, will have less liquidity than a more established company. Most of its capital will be tied up in company growth. Thus, from a prudent viewpoint investment in a small company would involve more risk and probably would be less prudent than investment in a larger company. In fact, this has been the situation in regard to trustee investments in a noncommercial context. Most States have legal lists in which investments can be made. A review of those lists show only major, large, established companies. Thus, a decision has been made that investments in smaller, growing companies are imprudent as a matter of law.

However, a fiduciary under the ERISA requirements is concerned not only with acting as a prudent man would but with the requirement as a matter of law to diversify his investments. The diversification by its very nature runs in conflict with the concept of a prudent man, particularly in light of the number of investments available to which money can be channeled in order to meet the nees of the beneficiaries and participants. The question then becomes how to best achieve diversification without undue impact on the prudent man requirements. It should be observed that diversification also involves other social goals which Congress has believed to be desirable. This involves the undue concentration of wealth in a few companies which will result in monopolization of industry. Congress has a legitimate concern in fostering competition which will necessarily follow from contributions to numerous companies. In addition, Congress has a legitimate interest in assuring growth in both new and better products.

A small investor or a smal businessman with a better way of doing business might never have that chance if he cannot get badly needed funds. Of course, he might get necessary funds at an expense to society by receiving moneys from organized crime at exces ve rates or in exchange for their participation in the business. Thus, the concept envisioned by S. 285 (Tax-Exempt Private Pension Investment Act of 1977) and S. 1745 (ERISA Small Business Paperwork Reduction and Investment Act) is desirable and should be adopted in order to provide necessary funds to small businesses.

As a private attorney, I am concerned that the bill attains this objective. It will do little good to pass a law which has so many restrictions that, in fact, investments into small companies will not follow. Having said that, it is not easy to state what Congress should do. My own belief is that unless the bill has built in an absolute protection for investments in small companies, no investment will follow. The reason for this is that ERISA exposes the fiduciary to considerable financial loss if he chooses wrong. Under section 409, the fiduciary is personally liable for any losses to the plan resulting from his breach. Under section 502, the fiduciary can be sued in a civil suit. The most important provision from an attorney's viewpoint is found in this section. That is section 502(g) which allows reasonable attorneys' fees and costs of an action to either party. Under this standard, a fiduciary would have to spend his own money defending a lawsuit in which he might ultimately end up paying the fees of the opposing counsel. It should be noted that under prior law courts have awarded attorneys' fees to opposing parties even in situations where the fiduciary or trustee prevailed. To complicate the matter, there is no adequate insurance that a fiduciary can obtain, and very few, if any, have adequate protection from indemnification agreements.

Applying this concept to the objectives of both bills, it is clear that unless the fiduciary obtains an absolute protection for investment in a small company, he will not take the risk. The bills do not contain any financial incentive to make it worthwhile for him to expose himself to this situation. Without an absolute no-risk protection, the fiduciary is faced with the following decisions: Should he invest in large established companies, particularly those on legal lists where his legal exposure is minimal; or should he invest in growing companies where he will have to explain his decision. From a private attorney's viewpoint, I would have to advise both the fund and the employer that without a no-risk provision in the act, investing in small business would be foolhardy. It does not take the wisest of individuals to realize that litigation under ERISA will probably involve suits going on for several years with legal fees to the individual's own attorney being anywhere from $10,000 to $40,000 per year. The financial exposure of the fiduciary could therefore run into hundreds of thousands of dollars for which he might not be reimbursed. Since many of the trustees do not have adequate financial resources, the very existence of a lawsuit, no matter what its outcome, could force them into bankruptcy.

Accordingly, while I believe both bills and the hearings on them have gone a long way in trying to understand the problem. I would recommend that it go the additional step of providing a no-risk zone for small business investments. How this is accomplished needs to be explored further. Some have suggested that this could ~~be done~~ by a fixed percentage. However, I would assume that there would be other alternatives, and there could even be modification of these percentage requirements. There could be different standards based on the size of the company and its growth potential. However, whatever formula is adopted unless a no-risk zone is established, this legislation will not encourage small business investment.

I would like to add that had ERISA not been passed probably the law would have developed somewhere along the lines of what I have just mentioned. Many persons believe that the prudent man rule as applied to an individual's estate has been applied in the same conservative manner regarding employee benefit funds. However, this is not correct. While there is not a wealth of law in this area, it is clear that courts would permit greater diversification of investments of employee benefit funds. For example, *Garment Workers* v. *Jacob Reed's Sons*, 83 F. Supp. 49 (E.D. Pa. 1949), permitted investments in the form of loans to employees. This would not be a permissible investment in regard to the handling of an individual's estate. Thus, the courts did recognize the need for greater diversification in investments prior to ERISA. Legislating changes in ERISA to make clear that small business can continue to receive investment capital will return the Act to the road it was on prior to 1974.

I want to thank the Committee for the opportunity to express my views and would welcome any questions the Committee might have.

Senator NELSON. Our next witness is Mr. Peter H. Vermilye, chairman, Alliance Capital Management Corp., Boston, Mass.

Mr. Vermilye, the committee is very pleased that you are willing to take the time to come and present your testimony. It will be printed in full in the record and you may present it however you desire.

STATEMENT OF PETER H. VERMILYE, CHAIRMAN, ALLIANCE CAPITAL MANAGEMENT CORP., BOSTON, MASS.

Mr. VERMILYE. Thank you.

I appreciate the opportunity for us to give our thoughts and appreciate your attention.

My oral testimony, I will give most, but not all of the written material here.

My firm manages about $3 billion of discretionary assets and $3½ billion of nondiscretionary assets—mostly pension funds. We have offices in about seven cities. I am also chairman of the investment committee at Boston University and a trustee of the church pension fund. In 1975, I served on the New England Regional Commission and a capital and labor task force, and last year for a similar one in the Commonwealth of Massachusetts, and addressed some of the problems that you are concerned with on availability of capital.

For a number of years I managed the pension equity investment at J. P. Morgan & Co. and Morgan Guaranty Trust. My associate, Ms. Jane Mack, is a member of the Advisory Committee on ERISA to the Department of Labor and she has shared some of her thoughts with me.

As we all know the pension investments play a very important part in our capital flow, and really are one of the main rudders that guide our economy.

The influence of ERISA on the attitudes of trust companies and investment firms that invest pension funds has been profound. Its investment provisions are reasonable and temperate. They are also vague and not clearly defined. The potential liabilities is creates personal and corporate with a vast broadening of the parties that can sue with costs defrayed have in this litigious era terrified some pension investors.

A common understanding in the investment community is that no one will know what is permitted under ERISA until suits have been brought and the courts have ruled. It is not surprising that pension investors now avoid issues about which a question may arise in the face of potential huge liability, legal costs, and damaging publicity.

James Hutchinson, a very able Administrator of ERISA, his successor, and the advisory committee have issued helpful interpretations on which we fully agreed on the meanings of ERISA, but they are not binding on the courts.

Another development taken in conjunction with ERISA has heightened pension investor's concerns.

The *Bank of New York* v. *Spitzer* case and other court decisions and settlements have raised the specter that trustees and investment managers can be held responsible for one or two unsuccessful investments in a fund that overall has performed very well. That has alarmed pension investors. It denies the very nature of investing—diversification is essential, and in any diversified portfolio events are going to turn against some holding. Investment judgment never bats 1,000. A business executive is judged by the overall success of his company—he is not fired and fined if nine products succeed but one fails.

The validity of *Bank of New York* v. *Spitzer* is questioned by many lawyers, and even if it prevails in certain circumstances, its applicability to ERISA is not likely. James Hutchinson has made helpful statements on this issue. But as long as the possibility exists, pension investors face a possible hornet's nest that has to affect their actions.

A major unfortunate result of ERISA so far is to encourage investment in large, safe companies and to discourage investment to moderate sized firms.

Investment in the latter obviously provides major social benefits. But pension investors responsibility is to the plan beneficiaries, and such investments can be made only if they provide a return at least equal to other equity investments in relation to risk. Properly diversified, selected, and timed, in proper proportions and judged over sufficient length of time, this has been the case. The T Rowe Prive New Horizons Fund and the Morgan Guaranty Special Situations Fund have been among the more successful investment vehicles. The most successful investments made by the largest and most successful institution equity investor, Morgan Guaranty in Avon Products and Schlumberger, were first made in the 1950's when those companies were of modest size and little known, and would probably be avoided today by many investors.

Two steps by Congress would go a long way toward enabling pension investors to prudently broaden their approach. The alternative is to leave it to the lengthy, expensive, and confusing court process.

We strongly endorse the provision in Senator Nelson and Senator McIntyre's bill, S. 1745, section 11, that the size of a business alone would not disqualify such an investment under the prudent man standard.

We would also like to see spelled out in legislation that a plan's investments should be judged by the overall prudence and success and not by a single investment. A pattern of imprudence should have to be established to create liability, not a single unsuccessful investment.

We do not think permitting a specific percentage to be invested in smaller companies, as Senator Bentsen's bill, S. 285, provides, is desirable. Pension funds have different objectives and other characteristics, and are supported by companies and industries of varying strengths, and a blanket provision is not appropriate. Such a provision might also lead to the slighting of the standards of prudence other than size that must apply to all investments.

Any legislation amending ERISA providing that companies should not be ruled out solely because of size should make clear that the standards of prudence still apply to smaller investments—thorough investigation, sound businesses, able management, et cetera.

Senator, there is one other point I would like to make at this time in answer to the question you addressed to Hal Bigler—tax changes that would encourage investment in moderate size companies.

The proposed revision of capital gains tax is making tax comparable in other kinds of investment accentuates and brings to full flower one inequity. The Government is a full partner now or will be when you make a profit. But when you lose money in capital gains, it is all your loss. It is as if you went to a parimutuel and the house would take half the profits and the loss is all yours. Those losses have been very difficult and have to be very discouraging to people taking any kind of capital risk for potential gain. Therefore, I think particularly if capital gains become taxed equal to other incomes, there should be a provision that capital losses can be offset against income to the full and not to the very modest amount that is now provided.

That is all I have to say.

Senator NELSON. You are talking now of so-called unearned income, in the realm of capital gains.

Mr. VERMILYE. Yes.

Senator NELSON. Thank you very much. I appreciate your taking the time to come and present your testimony.

I might say that Senator Hathaway was to be here and I had another commitment. Therefore I will not ask as many questions as I wanted to ask you. I may submit additional questions because I have got to conclude the hearings shortly, because Senator Hathaway did not get here to take my place.

[The prepared statement of Mr. Vermilye follows:]

STATEMENT BY PETER H. VERMILYE

I am chairman of Alliance Capital Management Corporation. We manage in seven cities about $3 billion of discretionary assets and $3½ billion nondiscretionary, primarily pension funds. I am also chairman of the Trustees Investment Committee of Boston University and a Trustee of the Church Pension Fund. I served in 1975, on a Capital and Labor Task Force for the New England Regional Commission, and in 1976, on a similar group for the Commonwealth of Massachusetts, that addressed the problem of capital available for business. From 1950 through 1964, I managed the pension equity investment at J. P. Morgan and Company and Morgan Guaranty Trust. From 1965 through 1969, I was a partner and Vice Chairman of the Investment Committee of State Street Research and Management and established their pension fund management.

My associate, Ms. Jane Mack, a Vice President of Alliance Capital Management, is a member of the Advisory Committee of the Department of Labor on ERISA.

The size of U.S. pension funds has been frequently cited in relation to the country's assets. The relative size will increase as pension assets grow. But the full importance and influence becomes apparent when we compare pension assets that are invested primarily in equities, with our aggregate equities, leaving out real estate and fixed income assets in which life insurance companies and other savings institutions concentrate; and then recognize that individual investors who hold most of the rest of equities are steadily liquidating them while pension funds are accumulating. Pension funds are the leading edge of our capital flow—and thus the rudder that guides our economy.

The influence of ERISA on the attitudes of trust companies and investment firms that invest pension funds has been profound.

Its investment provisions are reasonable and temperate. But they are also vague, not clearly defined. And the potential liabilities it creates, personal and corporate, with the vast broadening of the parties that can sue with costs defrayed, have in this litigious era terrified some pension investors. The common understanding in the investment community is that no one will know what is permitted under ERISA until suits have been brought and the courts have ruled. It is not surprising that pension investors now avoid issues about which a question may arise in the face of possible huge liability, legal costs and damaging publicity.

James Hutchinson, a very able administrator of ERISA, his successor and the Advisory Committee have issued helpful interpretations with which we fully agree, but they are not binding on the courts.

Another development taken in conjunction with ERISA has heightened investors concerns.

The *Bank of New York* vs. *Spitzer* case and other court decisions and settlements have raised the spectre that trustees and investment managers can be held responsible for one or two unsuccessful investments in a fund that overall has performed very well. That has alarmed pension investors. It denies the very nature of investing—diversification is essential, and in any diversified portfolio events are going to turn against some holdings. Investment judgment never bats 1.000. A business executive is judged by the overall success of his company—he is not fired and fined if nine products succeed but one fails.

The validity of *Bank of New York* vs. *Spitzer* is questioned by many lawyers, and even if it prevails in certain circumstances its applicability to ERISA is not likely. James Hutchinson has made helpful statements on this issue. But as long as the possibility exists, pension investors face a possible hornets nest that has to affect their actions.

A major unfortunate result of ERISA so far is to encourage investment in large "safe" Companies and to discourage investment in moderate sized firms.

Investment in the latter obviously provides major social benefits. But pension investors' responsibility is to plan beneficiaries, and such investments can be made only if they provide a return at least equal to other equity investments in relation to risk. Properly diversified, selected and timed, in proper proportions and judged over sufficient length of time, this has been the case. The T Rowe Prive New Horizons Fund and the Morgan Guaranty Special Situations Fund have been among the more successful investment vehicles. The most successful investments by the largest and most successful institution equity investor, Morgan Guaranty in Avon Products and Schlumberger were first made in the 1950's when those companies were of modest size and little known.

Two steps by Congress would go a long way towards enabling pension investors to prudently broaden their approach. The alternative is to leave it to the lengthy expensive and confusing court process.

We strongly endorse the provision in Senator Nelson's and Senator McIntyre's bill, S. 1745, Section 11, that the size of a business alone would not disqualify such an investment under the prudent man standard.

We would also like to see spelled out in legislation that a plan's investments should be judged by the overall prudence and success and not by a single investment. A pattern of imprudence should have to be established to create liability, not a single unsuccessful investment.

We do not think permitting a specified percentage to be invested in smaller companies, as Senator Bentsen's bill, S. 285, provides, is desirable. Pension funds have different objectives and other characteristics and are supported by companies and industries of varying strengths, and a blanket provision is not appropriate. Such a provision might also lead to the slighting of the standards of prudence other than size that must apply to all investments.

Any legislation amending ERISA providing that companies should not be ruled out solely because of size should make clear that the standards of prudence still apply to smaller investments—thorough investigation, sound businesses, able management, etc.

Senator NELSON. Our next witness is Mr. John Mutschler, president, John G. Mutschler & Associates, Minneapolis, Minn.

Mr. Mutschler, your statement will be printed in full in the record. You may present it however you desire.

STATEMENT OF JOHN G. MUTSCHLER, PRESIDENT, JOHN G. MUTSCHLER & ASSOCIATES, MINNEAPOLIS, MINN.

Mr. MUTSCHLER. I would like to deliver my statement in narrative form and submit my written statement for the record.

First, my background—I was born and raised on a farm north of Jamestown, N. Dak. I attended the University of North Dakota graduating in accounting in 1950 and from law school in 1953. I then went into the service and in 1955 when I got out of the service I went into the field of designing and administering pension and profit-sharing plans in the Minneapolis, North and South Dakota, Minnesota, and Wisconsin area.

In 1958 I formed my own business—John G. Mutschler & Associates—and our business, of course, is designing and administering pension and profit-sharing plans. By way of administration we do all of the paperwork, that is, trust balance sheets, financial statements, employee booklets, and meetings with the employees on an annual basis to explain their benefits.

We currently administer 343 plans of which 134 are defined benefit plans, 209 are defined contribution plans, mostly profit-sharing plans. Ninety percent of these plans are located in Wisconsin, Minnesota, Iowa, North and South Dakota, and cover approximately 3,300 employees. On an average basis each employee has $17,200 in equity, annual contributions per employee average $2,400, and their trust earnings are approximately $1,200. Average trust return is in the area of 7½ percent. The average plan has 13 participants. The average size plan is $190,000. Average contribution per plan is $23,000, and the total overall trust return was about 8½ percent last year. Total trust assets now approximate $65 million, average annual contributions are about $7,800,000. Trust earnings are now up to approximately $4 million annually. Trust assets break down as follows—bonds constitute $14 million, stocks are approximately $11⅓ million, cash and savings accounts $12 million, other investments $28 million.

Prior to ERISA we were installing approximately 25 to 30 new plans a year and terminating in the area of 2 to 3 plans. Most of the plans that were being terminated were because the companies were acquired by other larger organizations.

After ERISA, we are installing approximately 15 to 20 new plans a year. We have had to terminate 17 plans, about 3 percent of the total number of plans. Of these terminations, 10 plan terminations was directly related to ERISA.

Senator NELSON. What provisions were the main factors in the termination of these 10 plans?

Mr. MUTSCHLER. Of those 10, the largest one I can think of that covered the most employees was the fact that this company had not made contributions for the last 2 or 3 years. Many of the employees preferred to set up IRA—income retirement account—or had requested the corporation to terminate the plan so they could set up their individual plans under IRA.

The next largest plan I feel was a real tragedy. A company that was profitable, a growing company and it terminated its pension plan because of the 30-percent liability equity rule where if the pensions were not adequately funded, the company could be exposed to assessment of 30 percent of its net worth. It was basically an actuarial or a future cost concept. The owner was very concerned. He could not and I could not tell what his pension costs would be 10 years from now or 15 years from now, because pensions were based on the employee final 5-year average earnings. We have no real idea of what employees would be earning 10 years from now or when they came to retire. This exposure scared him and so he terminated the plan.

When we originally got approval of this pension plan, pensions were based on existing salaries rather than a 5-year average. But the Internal Revenue Service would not accept that definition and so the plan was terminated.

Other plan terminations resulted from what the corporations felt was excessive paperwork and the liability from the new prudent man rule.

Now the 10 that terminated—I feel extremely lucky that it was not four times that number. I am sure there was somewhere between 100 to 150 plans where the question was asked many times—should we terminate the plan, eliminate the hassle, eliminate the liability. We have at least temporarily convinced these companies to continue their plans; that ERISA would work out, at least from the paperwork standpoint, and that the prudent man rule could be followed by going to more conservative investments.

To go on—one of the things that I did note, though, in those terminations, that a number of them—I am getting back to this fact that some of the profit-sharing plans where the companies were not consistently profitable and missed contributions for 2 or 3 years, had considerable pressure from employees, since, the company was not putting in anything, to terminate the company plan so they could set up their own individual retirement accounts (IRA's). Of course, they could not do that—set up their own IRA's—as long as they were covered by a company plan. I feel that this is bad, that the law should provide that if the company makes only a partial contribution or no contribution, then an individual could have his own IRA plan and make up the difference in contributions on a deductible basis. I feel that there will be more plans terminated in the future if something is not done in this area. Where I think the danger is, is that employees that do request this, and who put the pressure on to terminate plans, are the savers. The vast majority of employees are not savers. The pension and profit-sharing plans are savings plans. People that do benefit from IRA are by nature savers. The vast majority of employees will not benefit, they will not take advantage of IRA's because they are not savers but feel they need all their wages to live on.

But to go on from there, I realize the primary purpose of this hearing is Senate bill 1745. Certainly, I like the single annual report. I do feel, and our experience indicates, that the new forms currently being used by the Internal Revenue Service, and the Department of Labor, are reasonable and the information that they request does not give us an undue burden. Certainly from a cost standpoint I have had to increase fees to my clients. Our largest single increase in costs, to date is due to the fact that we have to resubmit our plans, every plan I have, to the Internal Revenue Service for approval. So this one time cost to the employer of getting the plan approval is twice the normal annual cost.

With regard to section 4—employee statements, we have always done this and followed basically the outline of the provisions which are set forth, at least in the case of defined contribution plans.

With regard to defined benefit plans, I do feel that section B(I) should include something to the effect that vested benefits and earned benefits would be included in the statement of defined benefits.

Going on to the provision of having one member in small business represented on the advisory council—in my case all my plans I consider small business. Perhaps one or two employers would be considered large businesses, but no more than two. As I understand from reading the statistics, 93 percent of the plans have 25 or fewer employees. Possibly there should be more than one member representing small business. Possibly someone from the insurance industry which handles a great many of the small plans and also from the chamber of commerce should be on the council.

With regard to the modification of the prudent man rule—this morning when I sat here I heard comments from the three preceding witnesses, and of course my reaction is identical to theirs, if not stronger.

When trustees come for guidance in investment areas with the plans that I administer—I am licensed with the SEC as an investment counselor—normally we request the clients to use investment counselors in the Minneapolis area and other ones in other areas we have come across. These investment counselors without hardly an exception are investing—we see it in working in our investments of the trust funds—primarily in bonds, and stocks of the 100 largest companies in the United States. A lot of the trusts are going to insurance companies with fixed income guarantees, and other similar type of conservative investments.

On page 3 of my report at the bottom I have laid out the comments that I have just had from all the major investment counselors that I work with. They feel they must be superconservative. They must be defensive. They just cannot afford to take the risk of investing in any sort of venture capital companies or one that can be considered as having any risk. If they are wrong, they can be sued, their organization can be sued. In their minds, it just does not warrant taking a chance of making an investment in second and third tier stocks even if their past record, current financial position, and future prospects are exceptional.

One of the investment counselors made a lot of sense to me, and fits in with my own experience. Prior to ERISA, in formulating the investment philosophy for an average pension or profit-sharing plan, they would have predominately large companies paying dividends and well known, let us say, on the list of the top 100. They would also have some small local companies with growth potential—electronics, soft drinks, service industries, et cetera. The overall results, many times, was that some of the small companies would show dynamic growth and increase greatly in value which would offset the mediocre performance of the large older companies and in some cases the losses in the larger companies. Of course, Penn Central is an example of a large company going bankrupt.

An additional concern that the investment advisers feel and/or actually carry out is that if they make 10 percent rather than 6 percent, who really cares. But if they lose 2 percent, all the employees, the owners of the corporation that set up the plan are discouraged. Whereas before if the performance was bad, the worst that would happen was that the trustees would change advisers. Today the adviser is sued. That just is devasting to them. One investment counselor said, we—they as a group—have become paranoid about investing in small venture-type situations.

I do feel the provision in Senate bill 1745 regarding the prudent man rule certainly is needed and it is an improvement. I feel that section 9 could probably be expanded upon to state that an investment in a small company but not per se violate the prudent man rule. Some guidelines should be set up so that investment counselors do feel relatively free of risk in investing in smaller companies, assuming they are not negligent in their research and in their selection. They would be free from being sued and all the attending costs that go with being sued and that the investment results and the overall portfolio should be the guidelines for prudency rather than any specific investment.

As I said before, most of my businesses are small businesses. I understand statistically there are 13 million small businesses in the United States and only 600,000 have plans—1 in 20. My own experience was that we were putting in 25 to 35 new plans a year prior to ERISA. Now it is more like 15 to 20 new plans. Of the 18 plans we are now installing—12 are professional corporations, 6 are for average businesses. Professional corporations on the average have 6 or fewer employees, whereas normally businesses have in the area of 13 employees. So, what is happening is that we are covering fewer employees under the new plans. Smaller companies are no longer considering plans, because of cost and because of the prudent man rule. In the long run I do not think that this is in the best interest nor was it the purpose of the law to discourage new plans.

One of the biggest disappointments to my clients and to the small businesses I work with is the deletion of section 503(c) of the 1954 Revenue Code from the new law. That section dealt with and permitted corporations to borrow funds from their trusts if they put up adequate security and paid a reasonable rate of interest. This section also permitted the trust to lease equipment, and/or real estate to the company. Leasing equipment in my experience has been extremely profitable, normally resulting in a 15- to 22-percent average return to the trust.

This section also permitted the trustees to purchase conditional sales contracts, notes, et cetera, from the company as an investment by the trust as long as all business was carried out at arm's-length transaction. Most of my clients have looked at plans as being a double benefit. A benefit certainly for the employees since obviously they are savings plans designed to develop retirement benefits, termination benefits, and death benefits for them. Also the trust was a benefit to the company, that it could help the company to grow, since they could borrow funds, if they could provide adequate security and paid the going rate of interest.

I can think of three situations of companies located in Minnesota-Wisconsin that have been able to expand their business and create, just from being able to loan trust funds, at least 200 jobs. One company originally was about 40 employees and now there has been an addition of 450 employees. So the company grew from 40 to 500 employees since they installed their retirement trust. Part of their growth has come from their retained earnings, obviously. The balance is because they were able to use the trust funds to help build new buildings, to create additional working capital, and the loans were more than adequately protected by the security that was given.

Under ERISA we are not able to borrow funds any longer and in these three situations that I am thinking of specifically—contributions, prior to ERISA, were always 15 percent to the profit-sharing plans and the normal contributions to the pension plans. Since ERISA they now had to cut back profit-sharing contribution to 10 percent and may in the future have to cut back even further. One company last year made no contribution to its profit-sharing plan, basically because of ERISA.

The problem with most young growing companies currently is inflation. To illustrate, if a company is in the retail business and has an inventory of $10 million, and they have an inflation factor of 10 percent, the company has to make $1 million just to maintain the same inventory and $1 million for taxes. Obviously a company cannot afford contributions if they cannot use some of it to help take care of this inflation problem. Of my clients, 102 have borrowed trust funds. Sixteen have leased equipment and 12 have leased real estate back to the corporation. Eighteen have engaged in other similar type transactions. The trust returns, in my experience, on loans have been between 8 and 12 percent, and equipment leases have a 12- to 22-percent return. Whereas most plans to my knowledge who have engaged primarily in the stock market, 1969 and 1970, and 1973 and 1974 have resulted in very large trust losses. Some of our plans lost as much as 50 percent particularly in 1973 and 1974. These plans used investment counselors who presumably were being guided by the prudent man rule.

Approximately 2,200 employees are covered by plans that have borrowed trust funds and have never had a loss. The trusts either had interest income from secured loans, and/or lease income from leased equipment.

Approximately 1,000 employees have been covered by plans where we engaged in the stock market and over the last 10 years their average return is less than 5 percent, whereas the plans that have availed themselves of section 503(C) have averaged closer to 8 to 9 percent return and 10 percent in some years where interest rates were very high.

I do feel that the prudent man rule as developed under English law applied to situations that are somewhat different than pension and profit-sharing plans. They were applied to situations where property was left to someone to manage, as trustee, as a one-time transfer of property to be managed for children, spouses, other designated beneficiaries.

In a pension and profit-sharing plan we have two sources of income. One is the trust investment income. Two is contributions from the company. That is basically where the bulk of the funds come from, prior contributions, current contributions and hopefully future contributions.

Going back to my farm background—my dad always taught me—to practice good farming methods. In our area, it was dry farming, summer fallowing, killing the quack grass, taking good care of the land and if we did this it would take care of us. It would provide our income for a living, for education, for investment and for retirement. So I feel that it is prudent for the trustees to help the employer to grow, to produce profits so that the company can make contributions as long as there is adequate safeguards to protect employees, that is, adequate security for loans, and an "arms length" requirement for leases and other transactions.

That is the basic summary of my presentation and I do feel that we do have to do something additional to encourage small companies to consider pension and profit-sharing plans. Accountants are no longer recommending them, at least with the strong recommendations they used to prior to ERISA.

Basically, I do feel we are getting the paperwork in line. The prudent man-rule is the No. 2 problem. Three is the area where under prior law the trustees could use the funds to help the company grow, if possible.

Senator NELSON. Is that section 503(c) you are talking about?

Mr. MUTSCHLER. Yes.

Senator NELSON. You think that ought to be restored as it was?

Mr. MUTSCHLER. As it was. If there were pre-ERISA hearings showing abuses—I have been unable to find any hearings dealing primarily with 503(c) at least in the Minneapolis library. If there were, I would like to have someone give me access to them. If there were abuses, they should be corrected. I have not seen abuses.

In my report I had one situation where a piece of equipment was put up as security for a loan. There were three employees in the plan plus the owner. Two employees went into competition and under the pre-ERISA provisions in the plan they forfeited their interest. The plan was then liquidated, the company went out of business. When the plan was liquidated, the machine given as security for a loan to the company was sold and the price was not adequate, it was short by about $2,500. So this one employee did not get his share of the forfeiture. He got all the company contributions made for his benefits and all earnings and that is the worst I have seen happen. This is my 22 years of experience.

Senator NELSON. I think you raised a good point. I do not recall whether that specific section was addressed by anyone at hearings in—the old Labor Committee now the Committee on Human Resources—or in the Finance Committee. But, I would ask staff to check and see. Because as you pointed out, that provision was in the House bill and in conference it was eliminated. I remember that it was eliminated in conference, but I cannot recall whether there was any really specific history of abuse of that section. You say you have only seen that one problem in 20 years——

Mr. MUTSCHLER. In 22 years.

Senator NELSON. A $2,500 loss to one employee.

[The following letter was supplied for the record:]

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C., August 24, 1977.

HON. AL ULLMAN,
Chairman, Joint Committee on Taxation,
Washington, D.C.

HON. F. RAY MARSHALL,
Secretary of Labor,
Washington, D.C.

DEAR SIRS: During the recent hearing of this Committee on pension administration, reporting and investment policy, a witness raised the question of the rationale behind the elimination of Section 503(c) of the 1954 Internal Revenue Code and the substitution of other provisions under the Pension Reform Act of 1974 (ERISA).

The colloquy on this matter, which is attached, indicates we are not at all sure of its history. We would very much appreciate your furnishing us with any material from reports, testimony, or otherwise, which would enlighten us as to the background.

Very truly yours,

GAYLORD NELSON,
Chairman.

Enclosure.

Senator NELSON. You think that [Sec. 503(c)] ought to be restored as it was?

Mr. MUTSCHLER. As it was. If there were hearings—I have been unable to find any hearings dealing primarily with 503(c) at least in the Minneapolis Library. If there were, I would like to have someone give me access to them. If there were abuses, they should be corrected. I have not seen abuses.

In my report I had one situation where a piece of equipment was put up as security for a loan. There were three employees in the plan plus the owner. Two employees went into competition under the pre-ERISA provision to the plan they forfeited their interest. The plan was then liquidated, the company went out of business. When the plan was liquidated, the machine was sold and it was not adequate, it was short by about $2,500. So this one employee did not get his share of the forfeiture. He got all his contributions and all earnings and that is the worst I have seen happen. This is 22 years of experience.

Senator NELSON. I think you raised a good point. I do not recall whether that specific section was addressed by anyone at hearings in the Labor Committee, the old Labor Committee or the Finance Committee, but I would ask staff to check and see. Because as you pointed out, that provision was in the House bill and in conference it was eliminated. I recall that it was eliminated in conference, but I cannot recall whether there was any really specific history of abuse of that section. You say you have only seen that one problem you have seen in 20 years—

Mr. MUTSCHLER. In 22 years.

Senator NELSON. A $2,500 loss to one employee.

Mr. MUTSCHLER. What I am trying to do is compare that and possibly some other risks in some other areas with the fact that this encouraged many of my clients to set up plans to make contributions. That is the thing I am trying to do. The difference in earnings, you go and meet with these employees and you are in the stock market and you are in 69 or 70 or 73 and 74 and have to explain the fact that we are down 15 or 20 percent, the guy is close to retirement and invariably somebody will say, two more years like this and I will owe you money. What if I retire today, what do I get?

Well, you get today's value. Compared to the return, consistent returns I have seen in situations that I am speaking about. I have never seen yet where an employee's pensions were not started when he came to retirement or on terminations where he was not paid within at least a year, his interests or contributions became available. I have only seen basically good results come from this.

Mr. MUTSCHLER. What I am trying to do is compare that and possibly some other risks in some other areas with the fact that this provision encouraged many of my clients to set up plans and to make contributions. That is the point I am trying to make. The difference in earnings is dramatic, I go and meet with these employees and if their trust is in the stock market and the year is 1969 or 1970 or 1973 or 1974, I have to explain to them the facts that the trust lost 15 or 20 percent, some employees are close to retirement will ask if he were to retire then, would he lose the 15 to 20 percent. Invariably someone else will say, "Two more years like this and I will owe the trust money". "What if I retire today, what do I get." Well, we have to explain that they get today's value. Compare this to the high consistent returns I have seen in situations where trustees have used section 503(c). I have never seen yet where an employee's pension payments were not started when he came to retirement or on terminations where an employee was not paid within a year. I have only seen basically good results come from this.

Senator NELSON. Thank you very much for your very thoughtful testimony. We appreciate your taking the time to testify.

[Whereupon, the committee was adjourned at 11:25 a.m.]

[The prepared statement of Mr. Mutschler follows:]

STATEMENT OF JOHN G. MUTSCHLER, PRESIDENT, JOHN G. MUTSCHLER ASSOCIATES

First, I feel I should give you some information concerning my background and my business experience.

I was born in 1928 and was raised on a grain and cattle farm located north of Jamestown, North Dakota. I attended the University of North Dakota and was graduated in 1950 with a major in Accounting and Economics. In this same year, I passed the North Dakota CPA examination. I then entered law school and received my law degree in 1953, having been awarded the Order of the Coif. I personally financed my education, having farmed with my brother during the summer months and having worked in the college bakery during the school term.

I successfully passed the North Dakota Bar exam in 1953, and almost immediately thereafter I went into military service and spent the years 1953 to 1955 in the OSI, IG and USAF.

Upon completion of my service commitment, I was employed by Pension and Profit Sharing Service Co. of Minneapolis, Minnesota. My duties involved designing and administering pension and profit sharing plans.

In 1958, I started my own company which I still operate. My firm now employs 9 persons. We design and administer pension and profit sharing plans, all of them having been approved by IRS. While I am a registered investment counselor, I generally recommend someone such as Investment Advisors, Inc., to provide guidance to my clients in the investment of trust funds. My office currently handles 343 such plans for 253 corporations in the Wisconsin, Minnesota, Iowa, North Dakota and South Dakota area. Of these, 209 are defined contribution plans and 134 are defined benefit plans. The total assets of the various funds are about $65,600,000 and annual contributions are approximately $7,841,055. Approximately 3,300 employees are covered by these plans, the average equity of each one being close to $20,000. The average annual contribution for each covered person is about $2,400. In addition, to date, the average annual earnings have amounted to about 8.5 percent. The numbers of employees covered by each corporation under its plan or plans would average out at about 13.

My principal reason for appearing before you is to express my concern on the effect that the current ERISA rules might have on (1) the formation of new retirement plans, (2) the growth of existing plans, and (3) the creation of new jobs and/or the reduction of unemployment.

1. *New retirement plans.*—Prior to ERISA, my firm designed and installed between 25 and 30 new plans annually. The yearly average of terminated trusts was between 2 and 3. Since ERISA, the number of new plans per year has been reduced to 15 to 20 and the number of terminated ones has increased to 17, of which at least 10 were directly caused by the impact of ERISA. Many more (over 100) of our clients considered discontinuing their plans, but were convinced by our office to continue them. This might well be only a temporary respite.

To make matters worse, the numbers given above regarding new plans, while accurate, is somewhat misleading. Many of these were for professional corporations, each of which would only involve from 2 to 6 employees. For example, of the 18 new plans currently being designed in my office, 12 of them are for professional corporations and only 6 for other businesses.

I cite these figures because they dramatically show the impact of ERISA on small businesses. The variances from previous years in the number of new plans and in the termination of old plans are unique to the period covered by ERISA. Other Plan Administrators have had similar experiences. I am concerned that if this trend should continue, there will be additional millions of employees who will lose their retirement benefits from private sources and will have to rely exclusively on public retirement benefits such as social security.

It is true that the bulk of my experience is with what would be classified as small businesses. However, it is my understanding that 97 percent of the business community could be called "small business". In addition, the latest statistics which I have read show that 93 percent of the retirement plans have 25 or less participants. Obviously, the small business sector has been particularly affected by ERISA.

In my conversations with clients, it is apparent that the principal objection to ERISA is that these small businesses can no longer borrow (on a secured basis) from the trust funds. Previously, under Section 503(c) of the Internal Revenue Code, this was permitted. Naturally, the company had to provide adequate security and had to pay at least the going rate of interest. Because of this provision, most of my clients could see multi-benefits to be derived from the establishment of pension and/or profit sharing plans, benefits to both the employee and to the company. Certainly the employee gained by having a private retirement fund set up for him. As will be explained in more detail later, he also gained because under the regulations, his fund was able to earn a higher annual return, thereby increasing his retirement benefits. He also benefited in that through these procedures, his company was better able to expand, to become stronger and to ensure its stability and profit margin for the future. The company gained in that it tended to improve employee morale and employees productivity. The company was willing to set aside the annual contributions knowing that it could borrow Trust funds by providing adequate security and by paying the going rate of interest.[1] The company did not have to make an either-or decision. It did not have to determine whether out of its current profits it should contribute to an employee retirement plan or whether it needed the money to cover expansion programs or to cover inflated costs of inventory or other similar forseeable expenditures. It could do both.

A review of my records shows that of the companies for whom we administer employee trusts, 102 of them borrowed from the trust, 16 of them have leased equipment from the trust, 12 have leased real estate and 18 have engaged in other types of "arm's length" transactions with the trust, all of these activities permissible under prior Code Section 503(c). Others were definitely contemplating taking similar steps.

Now, these activities are specifically prohibited under ERISA. Based on my experience, including my conferences with both established and prospective clients, the prohibited transaction regulations of ERISA have been a prime cause in both the termination of existing plans and in the decrease in the number of new plans being created. As of now, I have limited my remarks to the effect the deletion of Internal Revenue Code Section 503(c), coupled with the adoption of Subtitle B, Part 4, Section 406 of ERISA has had on termination and creation of plans. More will be noted later as to the influence this has had on the growth of existing plans.

It is my considered opinion that the investment restrictions imposed on trustees by ERISA were not necessary and certainly were not desired. Early in life, my Father taught me that everything we had, our food, our clothes, even our health, was dependent on the land we farmed. If we put at least part of our farm income back into the land by adopting good farming practices such as summer following to conserve moisture, crop rotation, killing quack grass, picking rocks and purchasing good farm machinery, we would continue to have good crops and the money we might need for our well-being, education, retirement and all the other things we want out of life. I cannot forget that concept. The source of contributions to a retirement plan is the company. The good trustee must look to the continued good health, success, profitability and growth of the creator, the one who also is the main sustenance of the trust itself. No one has successfully convinced me that it is unwise, abusive or a misuse of trust funds to properly invest them on a secured basis with the prime originator and contributor—the company—where evidence shows that both the company and the participants can thereby both be benefited.

It is my understanding that in hearings held prior to ERISA, certain abuses under Section 503(c) were allegedly disclosed.

Originally, the costly paperwork required by ERISA was certainly a deterrent to the establishment and continuance of plans. Much of this has been alleviated by administrative rulings, and I have just read that the Senate Finance Committee has approved certain basic changes to be made by S-901 and S-1745 which would tend to further simplify the administration of ERISA.

[1] As an example, in my company's profit sharing plan, we own 160 acres of North Dakota farm land that has risen in value from $80 per acre to $600 per acre. I understand that I cannot lease it to my brother who is the best farmer I know, and currently farms over 25,000 acres.

Certainly, it also must be mentioned that the possible employer liability of up to 30 percent of its net worth discourages the setting up of defined benefit plans and has definitely been the reason for the termination of a pension plan covering 30 employees by one of my most profitable clients.

I also wish to mention that a number of my clients who have not been able to contribute consistently (about 5 percent) are terminating their profit sharing plans so that the individual employees can establish their own Individual Retirement Accounts (IRA's). I feel that this is wrong since only employees who are savers will establish IRA's and contribute consistently. I feel that the law should provide that if the company makes only a partial contribution or no contribution, then an employee could have his own IRA plan and contribute the difference between $1,500 and the company's contribution on a deductible basis.

2. *Growth of existing plans.*—Increases in a particular participant's trust fund account, assuming there are no voluntary or mandatory contributions by the employee, are primarily dependent on continued contributions by the employer and on trust earnings, and to a much lesser degree, on limited forefeiture possibilities. I have already mentioned the effect that the deletion of Internal Revenue Code 503(c) has on termination and creation of plans. It also has a double-barreled effect on the growth of those plans that are maintained.

Directly because of the new regulations defining prohibited transactions which no longer treats loans to an employer even with adequate security as an exemption, a number of my clients have reduced their profit-sharing contributions from a previous 15 percent to a current 10 percent, a couple of them having dropped to an even lower percentage. Over 500 participants have been affected by this reduction. Other additional clients are seriously considering a reduction in this year's contribution.

Assuming contributions were reduced from $1,500 to $1,000 annually and assuming an average yearly income of 5 percent on deposits over a 30-year span, the loss to the participant or employee would be about $28,398 in retirement benefits.

The other barrel produces results which are just as dramatic. The deletion of the exemptions to prohibited transactions originally in Section 503(c), together with a new "Prudent Man" rule regulation which will be discussed later, has had the effect of substantially reducing the annual earnings of the trust assets.

In general, companies borrowing money from trust funds were willing to pay as high or higher than the rates charged by lending institutions. Over the past 10 years, trusts which have loaned funds to the creator company have averaged annual trust earnings of from 7 percent to 10 percent. Over the same period, those who have invested in the stock market have averaged less than 5 percent annual income. If annual contributions of $1,500 were made to participant's account for a 30-year period, the balance in the account at the end of the term at a 9 percent annual return would be $222,870. At 6 percent this same balance would be only $125,700, or $97,170 less than the participant could receive in retirement benefits.

Based on my own experience, the best return on investment has been made by those trusts which loaned some of their assets to the company. The interest rates on these loans have been between 8 percent and 12 percent annually and where leased equipment was involved, the return has been between 12 percent and 22 percent before income taxes. I have never seen an instance where these former investment regulations were abused or where there was a loss of company contributions or trust earnings. Only in one instance did an employee experience a partial loss and this was on forfeitures of two terminating employees who forced the business to close, and who forced a sale of a particular machine which had been pledged as security.

On the other hand, I have noted large losses which were experienced in the stock market in 1969 to 1970 and again from 1973 to 1974.

If the effects of reduced contributions as well as reduced annual income are combined, the results are very startling, actually drastically so. Assuming $1,500 were contributed annually and accumulated at 8 percent per year, the balance in the trust account at the end of 30 years would be $183,519. If only $1,000 were contributed annually to this account and the annual income was 5 percent, the balance at the end of 30 years would be only $69,761. This means that this employee would have lost almost $113,758 in possible retirement benefits.

Prior to ERISA, fiduciaries to a large extent were controlled by a "Prudent Man" rule. The standards for those who professed to be experts were even higher than for others. However, the trust agreements often contained exculpatory clauses which generally have been upheld by the courts unless clear abuse was shown. In essence, however, the duty was based on common law originating in an 1830 case (Harvard College vs. Amory) as expanded through the years.

ERISA has added new dimensions in its "Prudent Man" definition. While the common law required the fiduciary to exercise his best skills, ERISA requires the fiduciary to act in accordance with a person "familiar with such matters." In other words, it would appear that under ERISA, a fiduciary will be measured not just by the skill and care of a prudent man or by the skill and care as possessed by the particular fiduciary, but rather by the skill and care of the very best in the field. In addition, the fiduciary cannot be relieved of his liability by any agreement provision. The personal liabilities for any breech of the provisions of ERISA could be staggering and are further compounded by the Internal Revenue Code provisions.

I am seriously concerned that because of the new Prudent Man rule, the trustees and investment advisors will become extremely conservative, and the effect will be noticable dimunition in the growth of employee accounts. Only one of the many investment advisors we work with in administering our 343 trusts has stated that his investment philosophy has not been altered by ERISA. Even in his case, he admitted that he now selects 8 to 10 stocks for a typical trust portfolio, rather than 4 to 6 stocks recommended prior to ERISA.

One investment advisor servicing about 18 trusts stated that in his opinion all of the advisors were "paranoid" about investing in anything other than savings certificates, AAA rated bonds and AT&T or other blue chip stocks which are being purchased by institutions. This same person told me that four of his 18 trusts had been terminated, and that the vast majority of small companies he deals with as a stock broker are no longer interested in setting up new plans.

Still another reputable investment advisor states he is "gun shy" of exposing himself and his firm to possible lawsuits based on his recommending any investments which have even a moderate degree of risk. Anything he recommends must be of the highest quality and must be a leader in its field. He couldn't think of a situation where he would recommend a "new issue" or a "third tier stock" such as a local over-the-counter security unless the institutions were also recommending and purchasing it. He felt that it was no longer feasible to include in a diversified portfolio securities of small, growing companies which would produce high profits to offset the poorer action of many large companies favored by institutions, and that in the long run, this would be harmful to the future growth of the trust funds. I have had a long association with this man. I know of his outstanding reputation in the investment field and I value his judgment highly.

I have conferred with many other trustees and investment managers. The gist of what all of them say is as follows:

1. They must be super cautious.
2. They must be defensive.
3. Life is too short to take chances on good quality, small companies. If you're right, you're just doing your job, but if you're wrong, you are going to be sued and no matter how good you are, you can't pick winners all the time.
4. Under the old law, if the trust lost money, the trust changed advisors. Now, the employees will probably sue if the trust loses money or even just one issue.
5. If you do invest in equities, you better be certain of the quality.
6. No venture capital investment should be made.

All of this seems to be to the detriment of the growth of the trust funds as well as against what appeared to be government policy of promoting small business and breaking up large corporations. In essence, ERISA has forced equity investments to be made only in the very large, quality corporations. I have already explained how decreased earnings can drastically curtail the growth of retirement accounts. Things might even get worse. Under the "Prudent Man" rule, fiduciaries might be sued for not making sufficient investment income. So far, it appears that the courts have concentrated on the risk of loss, but there are new theories that claim the possibility of gain must also be taken into account.

If the investments of a particular fiduciary are to be compared with the results of the very best in the field, it is not inconceivable that somewhere along the line he will subject himself to liability. I shudder to think what might then happen to our retirement plans.

3. *Creation of new jobs and reductions of unemployment.*—I have previously stated that many of my clients availed themselves of the opportunity permitted under Section 503(c) of the Internal Revenue Code, and did borrow money from their trust accounts. This money was primarily used for expansion purposes. I estimate that these loans which helped one company grow were directly respon-

sible for creating more than 400 new jobs. This obviously also started a chain reaction wherein all of the other companies dealing with my client, from construction man to supplier, were all helped as it provided them additional business.

In summary, I feel that the biggest deterrent to the establishment of new plans for small companies and to the growth of existing plans has been the elimination of the exceptions to prohibited transactions as originally contained in Section 503(c) of the Internal Revenue Code. I believe that a return to the old regulations with proper safe guards would greatly benefit employer, employee and the whole structure of the company's economy and society. The removal of private contributions from the retirement program of our citizens would have catastrophic effects, and it would appear that this would be directly contrary to Congressional intent. Along with this, the sections covering the "Prudent Man" rule and perhaps diversification might have to be altered so as to allow the trust investments for which I am appealing.

I have been asked to comment on S-1745. I believe that a single anunal report would significantly reduce the unnecessary paper requirements, and would reduce administrative costs. I believe this is also covered in S-901.

The addition of a Small Business member to the ERISA Advisor Council makes good sense. Ninety-seven percent of the business community can be classed as "small business" and 93 percent of the pension and retirement plans have less than 25 participants. In a council of 15 to 16 members, it would seem there should be more than one member representing "small business." Our office always has given annual statements as described in Section 4 of S-1745. In addition, in most instances, we also have met with the employees, have explained their plan and their annual statement to them, and have tried to answer any questions they might have.

Respectfully submitted.

JOHN G. MUTSCHLER.

APPENDIX A

Communications Received by the Committee Expressing an Interest in These Hearings

U.S. Senate,
Committee on Armed Services,
Washington, D.C., May 26, 1977.

Hon. Lloyd Bentsen,
Chairman, Private Pension Plans Subcommittee,
Washington, D.C.

Dear Lloyd: I regret that I was unable to attend the joint hearings of the Private Pension Plans Subcommittee of the Senate Finance Committee and the Senate Select Committee on Small Business on the administration, reporting and investment policies under ERISA.

I have been concerned for some time with the reporting burdens which the present administration of ERISA is imposing, particularly upon smaller pension plans. As you know, many employers with small plans are contemplating their termination, if they have not already done so. Clearly, this was not the intent of Congress in passing ERISA, and I commend you for your efforts to address the problems of overlapping jurisdiction in the administration of the Act, as well as simplification and reduction of reporting requirements. I chaired a similar joint hearing early last year, and I am fully aware of the need for expeditious reform.

I therefore would like to take this opportunity to commend to you the enclosed copy of a statement by Stanley H. Hackett, Associate General Counsel of the National Association of Pension Consultants and Administrators, Inc., regarding S. 901. The NAPCA has been most involved in this area, and I have discussed the need for reform with them on several occasions. As a representative of those who provide consultative services to primarily smaller plans, I believe their comments will prove most pertinent to the Committee's inquiry, and I would ask that a copy of Mr. Hackett's May 16, 1977, letter to Mr. Michael Stern be included in the hearing record.

Thank you for your assistance in this matter.

Sincerely,

Sam Nunn.

Henkel & Lamon, P.C.,
Atlanta, Ga., May 16, 1977.

Re S.901.

Mr. Michael Stern,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Dear Mr. Stern: Pursuant to the Committee's press release of May 12, 1977, we respectfully submit for consideration and inclusion in the legislative record the following comments with reference to S. 901. These comments are submitted on behalf of the National Association of Pension Consultants and Administrators, Inc. (NAPCA).

NAPCA is an organization of individuals and firms who provide consultative, administrative and insurance, annuity, and/or mutual fund brokerage service to employee benefits plans. The plans served are primarily smaller plans (under 50 participants) and include both welfare and pension benefit plans.

By virtue of their close advisory role to their client plans, NAPCA's members are on ERISA's "firing line", and are intimately familiar with the implementation problems which have plagued ERISA. The specific problems have been particularly acute in the area of reporting/disclosure, including forms and deadlines, and in the area of prohibited transactions/fiduciary responsibility, where the uncertainty of the statutory requirements together with the inability of the agencies to timely publish needed exemptions and clarifications has caused unnecessary disruption of the private pension system. The common denominator of many of the problems in these areas is the overlapping jurisdiction of various regulatory agencies, and particularly the dual jurisdiction of the Internal Revenue Service and the Department of Labor. It would appear that no one short of the President of the United States is in a position to resolve effectively conflicts between the agencies, at this time.

We realize that progress has been made in the implementation of ERISA, and, quite candidly, we compliment the agencies for their progress to date. However, such progress has come only after an inordinate amount of time, expense and hard work on the part of the Congress, the agencies and the public. We believe resolution of the jurisdictional problems is essential if ERISA is ever to be fully implemented. We further believe that the jurisdictional problems are institutional and have no reason to believe that the situation will improve absent a legislative change.

There appear to be two basic philosophies as to how the jurisdictional problems might be addressed. One is the concept of "statutory consolidation of functions" as exemplified in H.R. 4340, introduced by Congressmen John Dent and John Erlenborn in March, 1977. The second is the concept of "statutory allocation of functions" as exemplified in S.901. While either approach would undoubtedly improve the existing situation, it is our considered judgment that consolidation is essential to the implementation of a comprehensive and consistent federal policy toward employee benefit plans. Furthermore, we are concerned that the allocation approach of S.901 does not address an inherent area of jurisdictional overlap.

Under S.901, the Internal Revenue Service would be given jurisdiction over minimum standards, (e.g., vesting, funding, participation) of qualified retirement plans. The Department of Labor would be given jurisdiction over fiduciary responsibility and prohibited transactions. However, the Internal Revenue Service would retain jurisdiction over plan qualification procedures, the basic requirement of which (under Internal Revenue Code Section 401(a)) is that the plan be created, organized and operated for the "exclusive benefit" of employees and their beneficiaries. The "exclusive benefit rule" of the Internal Revenue Code is inextricably related to the fiduciary standards set forth in Title I of ERISA, and we do not believe the two concepts can be divided without compounding the jurisdictional problem.

We would like to note our strong support of other provisions of S.901, relating to simplification and reduction of ERISA's reporting requirements and the concept of an expanded and expedited declaratory judgment procedure. While resolution of the jurisdictional problems should at the same time ease problems in these two areas, we strongly favor a statutory mandate for simplified reporting, particularly with respect to small plans, as well as a workable procedure for prompt judicial review of agency action (or inaction).

We appreciate this opportunity to comment on S.901, and will be pleased to comment further if the Committee desires elaboration.

Respectfully submitted.

STANLEY H. HACKETT,
Associate General Counsel,
National Association of Pension
Consultants and Administrators, Inc.

HENKEL & LEMON, P.C.,
Atlanta, Ga., July 8, 1977.

Hon. THOMAS J. MCINTYRE,
Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR MCINTYRE: I was delighted to have the opportunity of studying S. 1745 which you have introduced jointly with Senator Nelson, as the "ERISA Small Business Paperwork Reduction and Investment Act".

As Chairman of the Small Plans Impact Work Group of the Advisory Council on the Employee Retirement Income Security Act established under ERISA, I am pleased to report to you a number of developments which have recently occurred which will aid substantially in furthering the objectives of S. 1745.

At the last meeting of the Advisory Council on June 28, 1977, in Washington, the Council voted unanimously to recommend the following to the Department of Labor:

1. To urge Congress to amend § 104(a)(1)(B) of the Act to require filing of the EBS-1 Form 120 days after approval of the Plan by the Internal Revenue Service, rather than 120 days after "inception of the Plan".

2. To urge the Department of Labor to allow the use of Form 5500-C by small plans to comply with the provisions of the Act requiring that a Summary Annual Report be furnished to participants on an annual basis.

I would also like to point out to you that the Small Plans Impact Work Group has worked diligently with the Department to try to eliminate the paperwork burden which is surely causing the termination of many small plans.

Meidinger & Associates of Louisville, Kentucky, an actuarial and consulting firm, has recently completed a survey which shows some very interesting results concerning the reasons why small plans are terminated. Over 48 percent of the clients contacted by Meidinger indicated that the paperwork burden was the chief cause of Plan termination.

I hope you, Senator Nelson, Senator Nunn and other members of your Committee will continue your active efforts to reduce the paperwork burden and to restore the integrity of the small plan.

With best personal regards.

Cordially,

HARRY V. LAMON, Jr.

MINUTES OF THE SMALL PLANS IMPACT WORK GROUP—U.S. DEPARTMENT OF LABOR, APRIL 5, 1977

The following members were in attendance at the meeting: Harry V. Lamon, Jr., Chairman; Doug Hunter; Wes Jeltema; and Bob Albright, Chairman of the Reporting, Disclosure and Recordkeeping Work Group.

Others present at the meeting were as follows: Dallas Salisbury, DOL; Ted Woronka, Price Waterhouse & Company, Inc.; Allen Kirkpatrick, Price Waterhouse & Company, Inc.; Dan Beller, DOL; and Bod Roeder, DOL.

I. REPORT FROM DALLAS SALISBURY ON PWBP/OPPR POLICY PLANNING, RESEARCH AND EVALUATION ACTIVITY

Mr. Salisbury discussed the major project activity of his office including contract monitoring and contract development. He identified the contract studies underway which deal substantially with small plans, as follows:

A. Administrative costs of small plans, Price Waterhouse & Company, Inc., of Washington, D.C.

B. Effects of Title I on the costs of pension plans, ICF.

C. New plan formation statistics, ABT & Associates, Cambridge, Massachusetts.

D. Plan terminations, Hay & Associates, Washington, D.C.

E. Impact of prohibited transactions sections, ABT & Associates.

Of the contracts under development the following would deal substantially with small plans:

A. Welfare benefit plan study.

B. Portability and reciprocity in single employer plans.

C. Evaluation of vesting and participation standards.

D. Evaluation of participants' knowledge.

E. Evaluation of effects of specific exemptions and variances.

F. Methods of encouraging and maintenance of employee benefit plans.

G. Pension coverage and vesting.

Mr. Salisbury commented that some of these studies would probably be combined and predicted that 6 or 7 of the 15 studies listed under contract development (see Attachment 1) would ultimately be contracted.

Mr. Lamon requested that Mr. Salisbury provide the work group a list of studies that have been completed, and that the work group be notified when studies are completed.

Mr. Lamon distributed copies of an overview of reporting and disclosure he had prepared with an exhibit of charts listing all reports required to be made to participants and beneficiaries, the Department of Labor, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation under ERISA. (Attachment 2)

Recommendation.—The work group submitted charts as prepared by Mr. Lamon to the Department for review and official endorsement, and recommends that the charts be distributed by the DOL and made available for publication in various professional journals by a date sufficiently in advance of the Summary Plan Description filing deadline so as to be of assistance to filers.

II. PRICE WATERHOUSE REPORT

OMB approval was received on March 14 for two Price Waterhouse questionnaires, one designed for plans with 100 or fewer participants and one designed for pension consultants. Although the original intention was to use a comprehensive form for plans with from 10 to 100 participants and a shortened form for plans with from 1 to 9 participants, these forms were combined at the request of OMB. OMB's rationale was that only items requesting essential information should be included on the questionnaires and that if information was essential to collect from plans with from 10 to 100 participants it was also essential to collect (or attempt to collect) from smaller plans.

Based on comments received by OMB from interested parties the combined employer questionnaire was modified by deleting several questions, primarily ERISA related reporting requirements for which plans may not yet have incurred costs. These requirements will, however, be mentioned in the instructions as items that should be specified in the space provided on the questionnaire for "other ERISA related requirements" if the plan has incurred any costs in connection with them.

The questionnaire designed for pension consultants was approved without change. An additional questionnaire designed for banks and trust companies was withdrawn at the request of OMB because, while it was intended to provide useful supplementary data on the pre- and post-ERISA fees charged by these firms, it was not essential to achieve the objectives of the project. The work group suggested that this information be obtained informally through references to be supplied by Council members.

The employer questionnaire was mailed on April 4, 1977, to a sample of approximately 1,500 plans selected out of 10 stratifications developed from EBS-1 reports, and the pension consultant questionnaire to a sample of about 250 firms.

Collection of all survey data is expected to be completed by May 15, 1977. The final two phases of the study will be an analysis of the survey results, to be conducted during May and June, and development of an analytical model to evaluate the impact that changes in administrative costs have had on small pension plans, to be completed in July. The final report on the project results is to be submitted to the Department in September 1977. The work requested that the Department ensure that this final report is available in time for the September 20th meeting of the full Council.

III. SIMPLIFIED REPORTING FOR SMALL PLANS

The work group discussed the following proposal: That small plans be permitted to store information, subject to call by the agencies, rather than being required to file all information on an annual basis. (Bentsen, Nelson, Erlenborn)

The specifics of this proposal are as follows: Small plans would be required to file with the agencies only Form EBS-1, upon adoption of the plan and subsequent amendment. Participants would be entitled to inspect all plan records and documents once a year, and would be entitled to receive an annual statement of their account (beginning balance, additions, ending balance, vested interest). No Annual Reports or Summary Annual Reports would be required. The employers would be required to maintain records subject to random audit of the agencies.

In defining small plans, consideration should be given to a breakdown other than the present "under 100/over 100" classification. For example, distinctions in reporting requirements could be made for plans of the following sizes: 1–24, 25–49, 50–100, over 100. These numbers are not "magic"; they are illustrative. The small plans would have the requirements noted above at a maximum. Larger plans could have additional reporting requirements.

The key to successful implementation of the concept of replacing formal reports with audits is a qualified and competent field force under the jurisdiction and direction of an agency administrator.

With respect to the question of a definition of small plans on the basis of a breakdown other than the present "under 100/over 100" classification, the work group reviewed a number of possible breakpoints and concluded that for the present time the breakpoint for small versus large plans should continue to be considered 100 employees which ties in with OMB's action concerning this matter in connection with the cost impact study now being conducted by Price Waterhouse & Company.

The work group discussed this proposal in relation to current requirements concerning the content, format and distribution of the Summary Annual Report and the Annual Report.

Recommendation.—The Summary Annual Report should be eliminated and substituted with the requirement that appropriate information from the Annual Report Form 5500-C or 5500-K be reported to participants and beneficiaries by means of posting on public bulletin boards or by other simplified disclosure methods. Present requirements for Annual Report Form 5500-C and 5500-K should be retained.

This recommendation was referred to the Reporting, Disclosure and Recordkeeping Work Group for consideration in their study of current ERISA reporting requirements.

Mr. Lamon initiated discussion of a problem that has arisen from the requirement that Form EBS-1 be filed within 120 days after the plan comes into existence or becomes subject to ERISA, whether or not it has received a favorable determination letter from the Internal Revenue Service. In many cases the employer files the initial EBS-1 within the 120 day period during which the IRS is reviewing the plan and shortly thereafter is notified by the IRS that his plan must be modified before a favorable determination can be issued. This material modification necessitates the employer filing an amended EBS-1 reflecting the requested alteration.

Recommendation.—The filing deadline for the initial EBS-1 for new plans should be changed to within 120 days after the plan receives a favorable determination letter from the Internal Revenue Service. The filing deadline for the amended EBS-1 should be changed to within 60 days after the plan receives reaffirmation of qualified status from the IRS.

This recommendation was endorsed by the Legislative Amendment Work Group on April 28, 1977.

IV. SIMPLIFICATION OF ELIGIBILITY RULES FOR SMALL PLANS

After discussion of the following two proposals, the work group determined that further consideration was necessary and deferred a recommendation.

A. That small plans under 100 employees be entitled to exclude from coverage part-time and temporary employees. Specifically, small plans would be entitled to use the pre-ERISA rules allowing exclusion of part-time and temporary employees who customarily work less than 20 hours per week or 26 weeks per year as opposed to the 1,000 hour rule of ERISA.

B. That small plans be entitled to use a five year eligibility rule as opposed to one year and age 25.

V. SIMPLIFICATION OF ACTUARIAL REQUIREMENTS FOR SMALL PLANS

The work group discussed Mr. Bassett's statement at the March 22nd Advisory Council meeting that due to changing economic conditions and changing plan provisions, the annual actuarial certification requirement has resulted in actuaries actually performing annual actuarial valuations.

Recommendation.—A small plan under 100 employees should be required to have an actuarial certification once every three years as opposed to each year. (See page 26 of the transcript of Advisory Council proceedings, Tuesday, March 22, 1977.)

VI. SIMPLIFICATION OF SCHEDULE A

The work group discussed the following proposal: Schedule A (regarding insurance information) should be coordinated with Exemption Application D-183 with reference to commissions disclosure. In other words, regardless of the format ultimately adopted, it should be the same for both purposes.

After discussion the work group agreed to reaffirm its previous statements requesting the Department to (1) expedite a determination as to whether or not disclosure of fees and commissions information will be waived for the 1976 plan year, and (2) expedite publication of regulations setting forth reporting requirements for the 1977 plan year.

VII. FORM 5300

The work group considered a memorandum submitted by John S. Nolan of Miller & Chevalier (Attachment 3) concerning a conflict in filing requirements for revised Forms 5300 and 5301, which he feels may lead to termination of hundreds of small plans. The instructions for the forms provide that they must be filed in the district where the employer is located, or in case of plans of more than one employer, where the plan administrator is located. These instructions conflict with the Statement of Procedural Rules, section 601.201(o)(3)(xii), which provides that in case of industry-wide plans and other plans covering multiple employers where the covered employers are located in more than one district, requests for determination letters are to be considered by the district in which the trustee is located.

The work group had not been aware of this problem and decided to research the issue and, on the basis of the findings, to send an appropriate letter to the Internal Revenue Service.

There being no further business to come before the meeting, the meeting was adjourned at 11:50 a.m.

Respectfully submitted,

HARRY V. LAMON, Jr.,
Chairman, SPIWG.

ATTACHMENT 1

OFFICE OF POLICY PLANNING AND RESEARCH

CONTRACT LIST AS OF APRIL 4, 1977

Contract monitoring

(1) 3032 Study—Pension Rights of Federal Contract Employees;
(2) BLS Pre-ERISA pension analysis;
(3) Administrative Costs of Small Plans;
(4) Cost Impact of ERISA;
(5) ERISA and Collective Bargaining;
(6) New Plan Formation;
(7) Termination of Plans;
(8) Portfolios and ERISA;
(9) Economic Security Needs—Theoretical;
(10) Economic Security Needs—Profile of Sources; and
(11) Prohibited Transactions.

Contract development

1. RE-77-1—Oakland PERS Case Study;
2. RE-77-2—New England Retirement Law Commission Funding Study;
3. RE-77-3—Private Pension Policy Simulations;
4. RE-77-4—Labor-Hour Contract;
5. RE-77-5—Welfare Benefit Plans Study;
6. RE-77-6—Multiemployer Pension Plans Study;
7. RE-77-7—Portability & Reciprocity in Single Employer Plans;
8. RE-77-8—Evaluation of Vesting & Participation Standards;
9. RE-77-9—Evaluation of Participants' Knowledge;
10. RE-77-10—Evaluation of Effects of Exemptions and Variances;
11. RE-77-11—Women and Employee Benefit Plans;
12. RE-77-12—Methods of Encouraging and Maintenance of Employee Welfare Plans;
13. RE-77-13—Older Workers & Pension Plans;
14. RE-77-14—BLS Current Amounts Study; and
15. RE-77-15—Pension Coverage & Vesting.

ATTACHMENT 2

REPORTING AND DISCLOSURES AN OVERVIEW—HARRY V. LAMON, JR., HENKEL & LAMON, P. C.

I. ERISA: REPORTING AND DISCLOSURE PROVISIONS

A. Part 1 of Title I: 11 pages of small print.
B. Part 3 of Title II: 5 additional pages.

II. HISTORY TO DATE

A. EBS-1: Plan Description:

(1) Initial 20 page behemoth which required lengthy narrative responses and which probably caused many plan terminations.

(2) Present 6 page form on which the plan administrator simply fills in the blanks.

(3) Extensions for filing.

(a) Only first 2 pages and signature page of initial 20 page form were required to be filed by August 31, 1975.

(b) May 30, 1976 due date for simplified form for plans in existence as of January 31, 1976.

(i) July 30, 1976 extended deadline if matters beyond the control of the plan administrator made delay unavoidable.

(ii) DOL still unofficially seems to be accepting good faith late filings without imposing sanctions, although there are no guarantees.

(4) Regulatory exemptions.

(a) Unfunded or fully insured welfare plans with less than 100 participants.

(b) Welfare plans with less than 100 participants operating through a group insurance arrangement where there is a trust or association which receives premium payments from participating employers and makes a single premium payment to an insurance carrier.

(5) Commission on Federal Paperwork is considering a recommendation that the EBS-1 be merged with the 5500 series.

B. 5500 Series: Annual Return/Report.

(1) Simplified forms for smaller plans.

(a) Form 5500 for plans with more than 100 participants.

(b) Form 5500-C for plans with less than 100 participants.

(c) Form 5500-K for H.R. 10 plans with less than 100 participants.

(2) 1 copy to IRS and 1 copy to DOL for 1975 plan year.

(a) Deadline extensions.

(A) DOL.

(i) Initial deadline was last day of 7th month following the close of the plan year.

(ii) Deadline extended to 15th day of the tenth month following the close of the plan year.

(iii) Deadline further extended to 11½ months after the end of the plan year.

(B) IRS.

(i) Initial deadline was last day of 7th month following the close of—

(I) The employer's taxable year for single employer plan.

(II) The plan year for a multiemployer plan or other multiple-employer collectively bargained plan.

(ii) Deadline extended by IRS to 15th day of the tenth month following the close of such taxable year or plan year.

(iii) Deadline further extended to December 15, 1976, but only for returns otherwise due October 15 or November 15, 1976.

(b) IRS and DOL have amended 5500 Series instructions to provide that party-in-interest transactions need not be reported where an administrative or statutory exemption is applicable.

(3) Temporary elimination of Forms 5501, 5504, and 5505 for 1976 taxable or plan year.

(a) Due to demands of qualification process.

(b) Forms in question are IRS forms.

(i) Form 5501: Summary Statement for Two or More Employee Pension Benefit Plans.

(ii) Form 5504: Statement in Support of Deduction for Payments to Defined Benefit and Defined Contribution Plans.

(iii) Form 5505: Statement in Support of Deduction for Payments Made on Behalf of Self-Employed Individuals . . . .

(4) IRS has announced an optional *early* filing date for the 1976 5500 Series so that the forms may be filed with DOL and IRS at the same time.

(5) Trend seems to be in the direction of a unified filing.

C. Summary Plan Descriptions.

(1) Deadlines.
(*a*) May 30, 1976.
(*b*) Extension to March 31, 1977 given timely ERISA Notice
(*c*) March 15, 1977 regulations: further extension to July 15, 1977 re certain plans
(i) Plans adopted before December 2, 1976.
(I) Condition for extension: timely ERISA notice.
(II) Welfare plans: SPD must be filed with DOL and furnished to participants and beneficiaries on or before July 15, 1977.
(III) Pension plans: later of July 15, 1977 or 90 days after the issance of a determination letter by IRS (or the end of the IRC § 401 (b) period if no determination letter is requested).
(ii) Plans adopted on or after December 2, 1976 but before March 17, 1977.
(A) No ERISA Notice requirement.
(B) Deadlines are same as for plans adopted before December 2, 1976.
(iii) Plans adopted on or after March 17, 1977: statutory deadlines apply.
(A) Filing with DOL: within 120 days after the plan is adopted
(B) Distribution to participants by the later of—
(I) 90 days after a person becomes a participant or after a beneficiary first receives benefits, or
(II) 120 days after the adoption of the plan.
(2) Regulatory attempts at simplification and exemptions.
(*a*) Sample language re PBGC coverage and statement of ERISA rights.
(*b*) Plan merger provisions have been made less onerous.
(i) Proposed regulations: SPD of the successor plan, the merger agreement, and transitional benefit provisions to be provided immediately upon merger
(ii) March 15, 1977 regulations: merged plan participants to be furnished, within 90 days of the merger, an SPD of the surviving plan and a separate summary statement describing the effects of the merger; other documents, including themerger agreement, are to be available upon request.
(*c*) An unfunded union dues financed plan may comply with the SPD requirements simply by preparing a supplement, which, when combined with the LM-1 or LM-1A required to be filed under the Labor-Management Reporting and Disclosure Act, results in a package satisfying the SPD style, format, and content requirements.
(i) Employee organization constitution or bylaws may suffice as such supplement.
(ii) Such an unfunded union dues financed plan may also be exempt from having to file an EBS-1, the 5500 Series (with DOL), and summary annual reports (see DOL Reg. §§ 2520.104-26 and 2520.104-27).
(*d*) Only a July 15, 1977 supplement, possibly consisting only of a statement of ERISA rights, may be required if the plan administrator previously completed, filed and distributed the April, 1975 20-page EBS-1 or an SPD based on the proposed regulations or statute.
(*e*) Alternative method of compliance for furnishing pension plan documents to retired participants and their beneficiaries and separated participants with vested benefits.
(i) Only a supplement may be required with respect to a retired or terminated vested participant or beneficiary if an SPD or its equivalent has previously been distributed.
(ii) A serious question remains as to how individually tailored such an SPD or its equivalent must be; e.g., must it describe the plan as of the date of retirement, termination or commencement of benefits, or may it be based on plan provisions in effect as of some later date?
(iii) Updated SPDs and summary descriptions of material modification and changes in information need not be furnished to unaffected retired participants, terminated vested participants, and beneficiaries, but these persons must be notified of their right to receive copies of these documents upon request.

III. PROSPECTS

A. Continued regulatory efforts to consolidate and simplify ERISA's reporting and disclosure requirements and to exempt plans where feasible.

B. Legislative proposals.

ATTACHMENT 3

LAW OFFICES OF MILLER & CHEVALIER,
Washington, D.C., March 22, 1977.

Form 5300—Certain Small Plans.

HARRY V. LAMON, Jr., Esquire,
Henkel & Lamon, P.C.,
Atlanta, Ga.

DEAR HARRY: A memorandum on the matter I brought to your attention at the Advisory Council meeting today is enclosed. The Service is considering this now, and we hope for some early action. If a satisfactory solution does not occur by April 5, I hope your Work Group will consider it.

Sincerely,

JOHN S. NOLAN.

Enclosure.

MEMORANDUM—PLACE OF FILING FORM 5300

The new Forms 5300 and 5301 (revised June, 1976) provide that they must be filed in the district where the employer is located, or in case of plans of more than one employer, where the plan administrator is located. These instructions, however, conflict in part with the Statement of Procedural Rules, § 601.201(o)(3)(xii), which provides that in the case of industry-wide plans and other plans covering multiple employers where the covered employers are located in more than one district, requests for determination letters are to be considered by the district in which the trustee is located. This conflict presents a serious problem which, unless corrected, could lead to termination of hundreds of small plans.

A large number of small employers in the U.S. have adopted one or more standard plans developed by well-established pension consulting firms or institutional trustees. These plans traditionally have been adopted and administered at very low cost, dependent in part on the fact that the basic standard plans and amendments thereto, and adoption of such plans, have been approved by the IRS in the district in which the trustee is located (as provided in the existing IRS regulations cited above). Pension reviewers in such district have become thoroughly familiar with these plans facilitating amendments and adoptions.

If this system were changed to require the new Form 5300's reflecting ERISA amendments to be filed in each district where each separate small employer is located, the cost of obtaining approval for each such employer would be intolerable. As stated, hundreds of terminations would result.

The instructions for the new Forms 5300 and 5301 were apparently developed on the mistaken impression that these industry-wide plans, and other such plans covering multiple employers, have a single plan administrator. This is not the case. Usually each separate small employer names a person or committee at his place of business to serve as plan administrator, to facilitate relationships with employees, though all detailed administrative work, forms, actuarial studies and certifications, accounting certifications, and other such matters are handled centrally, so as to minimize cost, by the pension consulting firm in conjunction with the institutional trustee performing its fiduciary functions.

The new instructions would literally destroy a pattern of operations for small plans administered through highly reputable pension consultants which has worked well for 20 years or more at minimum cost to small employers. The long-established eixsting regulations (Statement of Procedural Rules) which have facilitated operation of this system should not be changed (indeed, they cannot properly be changed merely in the Instructions to Forms 5300 and 5301).

The new instructions seem prompted, in part, by the idea that the plans should be approved, if at all, by the district in which the annual reports (Form 5500) will be filed and audited. This is a misconception. The very purpose of ERISA in large part was to provide minimum standards to avoid widely-varying administrative results among different IRS districts. Approval by any appropriate IRS district is sufficient in view of the extraordinary guidance now available through IRS and DOL regulations. Approval of the plans in the trustee's district, and subsequent IRS audits in the employer's districts, has never proved to be a problem in the past in the case of these standard plans. If absolutely necessary, the IRS could require in these cases that copies of the Forms 5300 and the plan and adoption agreement as approved be filed in the employer's district after approval.

Everything possible must be done to minimize cost burdens on small employers, and avoid further terminations of such plans. Resolution of this problem by adhering to well-established past IRS administrative practice will serve those objectives.

HOUSE OF REPRESENTATIVES,
COMMITTEE ON EDUCATION AND LABOR,
SUBCOMMITTEE ON LABOR STANDARDS,
PENSION TASK FORCE,
Washington, D.C., April 1, 1977.

Mr. HARRY V. LAMON, Jr.,
Henkel & Lamon, P.C.
Atlanta, Ga.

DEAR MR. LAMON: Thank you for your letter of March 24, expanding on the comments you made on March 17th at the Subcommittee hearing regarding the effectiveness of the Labor Department's Advisory Council on Employee Welfare and Pension Benefit Plans. I fully agree with you that much of great value has been accomplished by the vigorous effort you and the other members of the Advisory Council have made. You and your colleagues on the Advisory Council have performed a significant public service, and I hope that this effort will continue.

Your suggestions regarding the classification of pension plans, modification of reporting requirements, and so on contain much of merit and interest. I am certain they will be fully reviewed as substantive ERISA amendments are considered by the Subcommittee later this year.

I would like to personally express my appreciation for the tremendous amount of assistance you have provided the Subcommittee, especially as it begins consideration of H.R. 4340, the Employee Benefit Administration Act of 1977. Through efforts like yours on behalf of the bill, I am hopeful we can successfully resolve the serious administrative problems which have developed under ERISA.

With every kind regard, I am
Sincerely yours,

JOHN H. DENT, *Chairman.*

MEIDINGER & ASSOCIATES, INC.—SURVEY OF TERMINATED PLANS, 1975-76

Category	Cause	Total participants	Average number of participants per plan	Number of plans	Percent of total plans
I	ERISA: Administrative—either cost of complying or maintaining plan.	1,280	34	38	48.7
II	ERISA: Minimum funding cost too high	1,140	163	7	8.9
III	ERISA: Fear of employer contingent liability.	701	78	9	11.5
IV	ERISA: Fear of fiduciary liability	230	77	3	3.8
V	Other—Business reasons	1,182	56	21	27.0
Total		4,533		78	

Note: 73 percent of the terminations were represented as caused by ERISA related reasons.

Category I represents a cause that was expressed as the cost of preparing forms, amending plans, keeping track of employee data in a new manner and other administrative burdens. This is not the cost of funding the plan, but rather the dollar and mental cost of maintaining the plan administratively.

Categories II through IV represent terminations as a result of the substantive provisions of ERISA.

The survey was not limited to defined benefit plans, but included defined contribution plans as well.

Meidinger & Associates, Inc.—survey of terminated plans—1975–76

[Size of employers in survey]

Number of participants:	Number of plans
Less than 10	12
10 to 49	34
50 to 99	14
100 to 199	13
200 or more [1]	5

[1] Largest was 800.

SEPTEMBER 8, 1977.

Mr. W. J. MCKEON,
Vice President, Personnel, Domain Industries, Inc.,
New Richmond, Wis.

DEAR MR. MCKEON: I certainly understand your concern over the excessive paperwork required by ERISA. I am enclosing a copy of the bill introduced by Senator Nelson and a statement by Senator Javits that should be of interest to you.

Although I am not on the Committees which have jurisdiction over this legislation I assure you that I am deeply concerned by this problem and will support any legislation which effectively reduces the unnecessary paperwork required by the federal government.

I am forwarding your letter to the Senate Select Committee on Small Business and to the Senate Finance Committee.

Let me know if I can be of any further assistance to you.

Sincerely,

WILLIAM PROXMIRE, *U.S.S.*

DOMAIN INDUSTRIES, INC.
New Richmond, Wis., August 19, 1977.

Hon. WILLIAM PROXMIRE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: Enclosed please find five annual reports directed to me covering five of our Company's benefit plans. Each of our 1,000 employees received a similar package.

These five reports consist of 17 pages of material that not 1 in 100 of our employees can begin to understand. Most were dispatched directly to the wastebasket.

It cost my company many hundreds of dollars in labor and material to comply with this requirement of ERISA and this is just one of several requirements that are equally counter-productive. Surely, there must be a better way to attain the objectives of the law with which I am not unsympathetic.

Earlier this year, I telephoned the government commission on Federal paperwork and they told me that the No. 1 complaint that they received by far, is concerned with ERISA.

Can't something be done to eliminate this wastefulness? We would rather put this additional money into additional benefits for our employees rather than in paperwork that is meaningless.

Yours very truly,

W. J. MCKEON,
Vice President, Personnel.

91-933 O - 77 - 28

July 15, 197.

To: All participants Under The Domain Industries, Inc. Long Term Disability Plan.

In accordance with the requirements of the Employee Retirement Income Security Act of 1974, you are being provided with this copy of the annual report form filed with respect to the Domain Industries, Inc. Long Term Disability Plan for its year ending April 1, 1976.

Plan participants may obtain copies of the following more detailed annual report information for a reasonable charge or inspect without charge: the latest full annual report including a list of certain party-in-interest transactions. To obtain a copy of any documents listed, write to the administrator asking for exactly what you want. The administrator will state the charge for specific documents on request, so that you can find out the cost before ordering. All the documents listed can be examined at the General Office of Domain Industries, Inc.

The name, address, and telephone number of the plan administrator are:

Domain Industries, Inc.
c/o Jack Kilby
215 N. Knowles Avenue
New Richmond, WI 54017
(715) 246-6511

DOMAIN INDUSTRIES, INC.

Form 5500
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Annual Return/Report of Employee Benefit Plan (With 100 or more participants)

This form is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 and section 6058(a) of the Internal Revenue Code, referred to as the Code.

2-
1975
This Form is Open to Public Inspection

Government use only ▶ |A| |B| |C| |D| |E| |F| |G| |H|

For the calendar plan year 1975 or fiscal plan year beginning April 1, 19 75 and ending April 1, 19 76

▶ All pension benefit plans with 100 or more participants file one copy of this form with the Department of Labor (DOL) and one copy with the Internal Revenue Service (IRS). File a separate form for each plan. Legible reproduction copies are acceptable.
▶ Welfare benefit plans with 100 or more participants file this form with DOL only.
▶ Pension benefit plans complete all items. However, annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 6, 9 and 10.
▶ Welfare benefit plans complete only items 1 through 18 and item 24.
▶ Note: *Do not file this form for:*
▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner employee participant. File Form 5500-K instead.
▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants. File Form 5500-C instead.
▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of sponsor (employer if for a single employer plan): Domain Industries, Inc.
Address (number and street): 215 N. Knowles Avenue
City or town, State and ZIP code: New Richmond, Wisconsin 54017

1 (b) Employer identification number: 39-0501180
1 (c) Telephone number: (715) 246-6511
1 (d) Employer taxable year ends: January 31, 1976
1 (e) Business code number: 2040

2 (a) Name of plan administrator (if other than sponsor): Same as sponsor
Address (number and street):
City, town, State and ZIP code:

2 (b) Administrator's employer identification no.
2 (c) Telephone number: ( )

3 Name, address and identification number of ☐ sponsor and/or ☐ plan administrator as they appeared on the last report file with DOL or IRS if not the same as in 1 or 2 ▶

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☒ Single employer plan
(b) ☐ Plan of controlled group of corporations or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple-employer-collectively-bargained plan
(e) ☐ Multiple employer plan (other)

5 (a) Name of plan: Domain Industries, Inc. Long Term Disability Plan
5 (b) Plan number: 5 0 3

6 Check at least one item in (a) or (b) and applicable items in (c):
(a) Welfare benefit plan: (i) ☐ Health insurance (ii) ☐ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☒ Other (specify) ▶ Long Term Disability
(b) Pension benefit plan:
(i) Defined benefit plan—(indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ ~~Other~~ money purchase
(E) ☐ Other (specify) ▶
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization or a governmental unit (section 403(b) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶
(c) Other plan features:
(i) ☐ Thrift savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

5/23/77 [signature]
Date — Signature of (employer) sponsor

Date — Signature of plan administrator

BEST COPY AVAILABLE

3-

Form 5500 (1975) Page 2

7 Number of active and retired participants and beneficiaries as of the end of the plan year (welfare plans complete only (a)(iii), (b), (c) and (d)):

(a) Active participants (employed or carried as active) (i) Number fully vested		
(ii) Number not fully vested		
(iii) Total		269
(b) Retired participants receiving benefits		
(c) Participants separated from employment and entitled to future benefits		4
(d) Subtotal, sum of (a), (b) and (c)		
(e) Beneficiaries receiving pension benefits		
(f) Total, (d) plus (e)		273

	Yes	No
(g) Has the number of active participants decreased at any time during the current year by more than 20% from the number of those participating at the beginning of the plan year?		
(h) Has the number of active participants decreased at any time during the current year by more than 25% from the number of those participating at the beginning of the previous plan year?		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was the plan amended in this plan year?		X
(b) If "Yes," (i) Has a Form EBS-1 reflecting the amendment been filed with DOL?		
(ii) Have the accrued benefits of any participant under the plan been reduced?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS?		

	Month	Day	Year
(c) Enter the date the most recent amendment was adopted	03	30	73

	Yes	No
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during the year?		X
(b) If "Yes," were all trust assets distributed?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		X
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		
10 (a) In this plan year, was this plan merged or consolidated with another plan or were assets or liabilities transferred to another plan?		X

If "Yes," enter information about other plan(s):

(b) Name of plan(s)	(c) Employer identification number(s)	(d) Plan number(s)

(e) Has actuarial statement been filed with IRS as required for defined benefit plans? ☐ Yes ☐ No

11 Type of funding entity:
(a) ☐ Trust (benefits provided in whole from trust funds)
(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts
(c) ☒ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts
(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above
(e) ☐ Other (specify) ▶
(f) If (b) or (c) is checked, enter number of insurance carriers ▶ 1

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? ☐ Yes ☒ No
If "Yes," furnish the following information:

(a) Name	(b) Official plan position	(c) Relationship to employer, employee organization or person known to be a party-in-interest	(d) Gross salary or allowances paid by plan	(e) Fees and commissions paid by plan	(f) Nature of service provided to plan

4-

	Yes	No
18 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?	X	
(b) If "Yes," enter the maximum amount of loss recoverable ▶ $ 400,000		
(c) Enter the name of the surety company ▶ Hartford Accident & Indemnity Company		
(d) Does the plan, or a known party in interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		X
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		X

19 Information about employees of employer at end of the plan year (do not complete for multiemployer plans):

(a) Total number of employees	
(b) Number of employees excluded from plan coverage—	
(i) Minimum age or years of service	
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining	
(iii) Nonresident aliens who receive no earned income from United States sources	
(iv) Other (specify) ▶	
(v) Total employees excluded, sum of (i) through (iv)	
(c) Total number of employees not excluded from the plan, (a) less (b)(v)	
(d) Total number of employees covered under the plan	

	Yes	No
20 Is this plan a master or prototype plan? If "Yes," enter IRS serial number ▶		
21 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code?		
(b) Have you requested or received a determination letter from the IRS for this plan?		
22 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
23 (a) Is this a defined benefit plan subject to the minimum funding standards? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards?		

If "Yes," complete (i), (ii) and (iii) below:

(i) Amount of employer contribution required for the plan year	
(ii) Amount of contribution paid by the employer for the plan year	
Enter date of last payment by employer, for this plan year	Month / Day / Year
(iii) Funding deficiency, excess, if any, of (i) over (ii)	

24 Pursuant to DOL regulations, financial statements, schedules and, in certain circumstances, an independent qualified public accountant's opinion thereon are required to be attached to the copy of this form filed with the DOL. With reference thereto, please check the appropriate boxes:

(a) The accountant's opinion is ☒ not required OR ☐ required and is—
- (i) ☐ Unqualified
- (ii) ☐ Qualified
- (iii) ☐ Adverse
- (iv) ☐ Other (explain) ▶

(b) The schedules included are—
- (i) ☐ Investments at end of plan year
- (ii) ☐ Transactions involving plan assets and a party known to be a party in-interest
- (iii) ☐ Loans by the plan or fixed income obligations due the plan in default or classified as uncollectable
- (iv) ☐ Leases to which the plan was a party in default or classified as uncollectable
- (v) ☐ Transactions or series of transactions in excess of 3% of the current value of plan assets

Note: *Failure to check a box indicates the plan has nothing to report for that item.*

If additional space is required for any item, attach additional sheets the same size as this form.

5-

SCHEDULE A (Form 5500)
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Insurance Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.
▶ Attach to Forms 5500, 5500-C, and 5500-K filed with DOL, if applicable.
▶ Do not file with IRS.

1975
This Form Is Open to Public Inspection

For plan year beginning April 1, 1975 and ending April 1, 19 7

▶ Part I must be completed for all plans required to file this schedule.
▶ Part II must be completed for all insured pension plans.
▶ Part III must be completed for all insured welfare plans.

▶ Please complete all applicable items on this For
If an item does not apply, enter "NA".

Name of sponsor as shown on line 1(a) of Form 5500, 5500-C or 5500-K: Domain Industries, Inc.
Employer identification number: 39-0501180

Name of plan: Domain Industries, Inc. Long Term Disability
Plan number: 503

Part I Summary of All Insurance Contracts Included in Parts II and III
Group all contracts in the same manner as in Parts II and III.

1 Check appropriate box:
(a) ☒ Welfare plan (b) ☐ Pension plan (c) ☐ Combination pension and welfare plan

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year: Active (b) Employees	Active (c) Dependents	Retired (d) Employees	Retired (e) Dependents	Policy/Contract Year (f) From	(g) To
GSC 1775	269	-	-	-	4/1/75	4/1/

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
GSC 1775	Wm. M. Mercer, Inc. 1515 Northwestern Bank Bldg. Minneapolis, MN 55402	721.59	N/A	Service & Consultat

4 Premiums due and unpaid at end of the plan year ▶ $, contract number, or identification ▶

Part II Insured Pension Plans
Provide information for each contract on a separate Part II. Where individual contracts are provided, the entire gr of such individual contracts with each carrier may be treated as a unit for purposes of this report.

5 Contracts with allocated funds, for example, individual policies or group deferred annuity contracts:
(a) State the basis of premium rates ▶
(b) Total premiums paid to carrier
(c) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, enter amount
Specify nature of costs ▶

6 Contracts with unallocated funds, for example, deposit administration or immediate participation contract. Do not include portions of these contracts maintained in separate accounts:
(a) Balance at end of previous policy year
(b) Additions:
(i) Contributions deposited during year
(ii) Dividends and credits
(iii) Interest credited during year
(iv) Transferred from separate account
(v) Other (specify) ▶
(vi) Total additions
(c) Total of balance and additions, (a) plus (b)(vi)
(d) Deductions:
(i) Disbursed from fund to pay benefits or purchase annuities during year
(ii) Administration charge made by carrier
(iii) Transferred to separate account
(iv) Other (specify) ▶
(v) Total deductions
(e) Balance at end of current policy year, (c) less (d)(v)

7 Separate accounts: Current value of plan's interest in separate accounts at year end

6-

The CONTINENTAL INSURANCE COMPANIES

THE CONTINENTAL INSURANCE COMPANY • FIREMEN'S INSURANCE COMPANY • NIAGARA FIRE INSURANCE COMPANY
THE FIDELITY AND CASUALTY COMPANY • COMMERCIAL INSURANCE COMPANY • BOSTON OLD COLONY INSURANCE COMPANY
NATIONAL BEN FRANKLIN COMPANIES • SEABOARD FIRE & MARINE INSURANCE COMPANY • BUCKEYE UNION INSURANCE COMPANY
KANSAS CITY FIRE & MARINE INSURANCE COMPANY • THE GLENS FALLS INSURANCE COMPANY • PACIFIC INSURANCE COMPANY

360 West Jackson Boulevard, Chicago, Illinois 60606

PART III – SECTION D

Insurance Data From Carrier Not Maintaining Separate Experience Records for Specific Groups Covered

Name of Plan DOMAIN INDUSTRIES, INC.

1. Name of Carrier or Service or Other Organization THE CONTINENTAL INSURANCE COMPANY OF NEW YORK

2. a. Contract Identification (or Number) GSC 1775

   b. Data for Period: From APRIL 1, 1975 To APRIL 1, 1976

3. State the Basis of Premium Rate or Subscription Charge:

   $ .38 PER $100.00 OF INSURABLE PAYROLL.

4. Benefits Provided:

   DEPENDING ON AMOUNT OF SALARY TO A MAXIMUM OF $ 1,500.00 PER MONTH.

   BENEFITS COMMENCE ON THE 365TH DAY OF DISABILITY, AND ARE PAYABLE UNTIL AGE 65 FOR BOTH ACCIDENT AND SICKNESS.

   BENEFITS ARE REDUCED BY BENEFITS PAYABLE FROM PRIMARY & DEPENDENT SOCIAL SECURITY, WORKMEN'S COMPENSATION, OR ANY OCCUPATIONAL DISEASE ACT OR LAW WHEN TOTAL COMBINED BENEFITS EXCEED 70% OF THE INSURED'S MONTHLY SALARY.

5. Total Premiums or Subscription Charges Received From Plan . . . . . $ 14,431.77

6. Attach a copy of the latest financial report of the carrier named in Item 1. Report is attached. ☒ Yes ☐ No

7. Did the carrier or service or other organization named in Item 1 incur any specific costs in connection with the acquisition or retention of the contract or policy? ☒ Yes ☐ No
   If Yes, Provide the information in a. and b. below.
   a. Total commissions paid on Premium or Subscription Charges reported in Item 5 . . . . . $ 721.59
      Commissions paid to: WILLIAM M. MERCER, MINNEAPOLIS, MINNESOTA
   b. Any additional specific cost incurred in connection with the acquisition or retention of the Contract or Policy . . . . . $ N/A

Thomas M. O'Brien
Signature of Resident Officer
THOMAS M. O'BRIEN
ASSISTANT SECRETARY

3161-A6H-A 11/6-23-76

STATEMENT of CONDITION
of the

Name of Company The Continental Insurance Company

City and State New York, New York Zip Code 10038

Street or Building No. 80 Maiden Lane

On the 31st day of December, 19 75

John B. Ricker, Jr. President
(TYPE)

Geoffrey Davey Vice President & Secretary
(TYPE)

ASSETS OF COMPANY

	(NEAREST DOLLAR)
Bonds (Schedule D)	$ 167,726,2[illegible]
Stocks (Schedule D)	$ 260,254,2[illegible]
Mortgage Loans on Real Estate (Schedule B)	$ 3,114,1[illegible]
Real Estate owned	$ 18,312,00
Collateral loans (Schedule C)	$ 0
Cash and Bank Deposits	$ 21,460,7[illegible]
Agents' balances or uncollected premiums	$ 37,287,9[illegible]
Other assets	$ 184,747,8[illegible]
	$
Total Assets	$ 692,962,6[illegible]

LIABILITIES, SURPLUS AND OTHER FUNDS

Reserve for Losses	$ 192,855,6[illegible]
Reserve for Loss Adjustment Expenses	$ 16,684,9[illegible]
Reserve for Unearned Premiums	$ 102,044,3[illegible]
Reserve for Taxes	$ 4,706,76
All other Liabilities	$ 224,824,78[illegible]
	$
Total Liabilities	$ 531,119,56[illegible]

Special Surplus Funds	$ 0
Capital Paid up or Statutory Deposit	$ 53,566,360
Gross Paid in or Contributed Surplus	$ 53,863,370
Unassigned Surplus	$ 54,413,369

Surplus as regards Policyholders	$ 161,843,09[illegible]
Total Liabilities and Surplus	$ [illegible]

1-

July 15, 1977

To: All Participants Under The Domain Industries, Inc. Travel Accident Insurance Plan.

In accordance with the requirements of the Employee Retirement Income Security Act of 1974, you are being provided with this copy of the annual report form filed with respect to the Domain Industries, Inc. Travel Accident Insurance Plan for its year ending June 21, 1976.

Plan participants may obtain copies of the following more detailed annual report information for a reasonable charge or inspect without charge: the latest full annual report including a list of certain party-in-interest transactions. To obtain a copy of any documents listed, write to the administrator asking for exactly what you want. The administrator will state the charge for specific documents on request, so that you can find out the cost before ordering. All the documents listed can be examined at the General Office of Domain Industries, Inc.

The name, address, and telephone number of the plan administrator are:

Domain Industries, Inc.
c/o Jack Kilby
215 N. Knowles Avenue
New Richmond, WI 54017
(715) 246-6511

DOMAIN INDUSTRIES, INC.

2-

Form **5500**

Department of the Treasury
Internal Revenue Service

Department of Labor
Labor Management Services Administration

Annual Return/Report of Employee Benefit Plan (With 100 or more participants)

This form is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 and section 6058(a) of the Internal Revenue Code, referred to as the Code.

1975

This Form is Open to Public Inspection

Government use only ▶ |A| |B| |C| |D| |E| |F| |G| |H|

For the calendar plan year 1975 or fiscal plan year beginning June 21, 1975 and ending June 21, 1976

▶ All pension benefit plans with 100 or more participants file one copy of this form with the Department of Labor (DOL) and one copy with the Internal Revenue Service (IRS). File a separate form for each plan. Legible reproduction copies are acceptable.

▶ Welfare benefit plans with 100 or more participants file this form with DOL only.

▶ Pension benefit plans complete all items. However, annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 6, 9 and 10.

▶ Welfare benefit plans complete only items 1 through 18 and item 24.

▶ Note: *Do not file this form for:*

▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner employee participant. File Form 5500-K instead.

▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants. File Form 5500-C instead.

▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of sponsor (employer if for a single employer plan)
Domain Industries, Inc.

1 (b) Employer identification number
39-0501180

Address (number and street)
215 N. Knowles Avenue

1 (c) Telephone number
(715) 246-6511

City or town, State and ZIP code
New Richmond, Wisconsin 54017

1 (d) Employer taxable year ends
January 31, 1977

2 (a) Name of plan administrator (if other than sponsor)
Same as sponsor

1 (e) Business code number
2040

Address (number and street)

2 (b) Administrator's employer identification no.

City, town, State and ZIP code

2 (c) Telephone number
( )

3 Name, address and identification number of ☐ sponsor and/or ☐ plan administrator as they appeared on the last report filed with DOL or IRS if not the same as in 1 or 2 ▶ ....

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☒ Single employer plan
(b) ☐ Plan of controlled group of corporations or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple employer-collectively bargained plan
(e) ☐ Multiple-employer plan (other)

5 (a) Name of plan:
Domain Industries, Inc. Travel Accident Insurance Plan

5 (b) Plan number: 5 0 4

6 Check at least one item in (a) or (b) and applicable items in (c):

(a) Welfare benefit plan: (i) ☐ Health insurance (ii) ☒ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☐ Other (specify) ▶ ....

(b) Pension benefit plan:
(i) Defined benefit plan—(indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶ ....
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ Other money purchase
(E) ☐ Other (specify) ▶ ....
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization or a governmental unit (section 403(b) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶ ....

(c) Other plan features:
(i) ☐ Thrift savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

6/23/77 .... [signature] ....
Date — Signature of (employer) sponsor

....
Date — Signature of plan administrator

16-82763-1

3-

Form 5500 (1975) Page 2

7 Number of active and retired participants and beneficiaries as of the end of the plan year (welfare plans complete only (a)(iii), (b), (c) and (d)):

(a) Active participants (employed or carried as active) (i) Number fully vested		
(ii) Number not fully vested		
(iii) Total		375
(b) Retired participants receiving benefits		-
(c) Participants separated from employment and entitled to future benefits		-
(d) Subtotal, sum of (a), (b) and (c)		375
(e) Beneficiaries receiving pension benefits		
(f) Total, (d) plus (e)		

	Yes	No
(g) Has the number of active participants decreased at any time during the current year by more than 20% from the number of those participating at the beginning of the plan year?		
(h) Has the number of active participants decreased at any time during the current year by more than 25% from the number of those participating at the beginning of the previous plan year?		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was the plan amended in this plan year?		X
(b) If "Yes," (i) Has a Form EBS-1 reflecting the amendment been filed with DOL?		
(ii) Have the accrued benefits of any participant under the plan been reduced?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS?		

	Month	Day	Year
(c) Enter the date the most recent amendment was adopted	06	21	72

	Yes	No
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during the year?		X
(b) If "Yes," were all trust assets distributed?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		X
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		
10 (a) In this plan year, was this plan merged or consolidated with another plan or were assets or liabilities transferred to another plan?		X

If "Yes," enter information about other plan(s): (b) Name of plan(s) ▶	(c) Employer identification number(s)	(d) Plan number(s)

(e) Has actuarial statement been filed with IRS as required for defined benefit plans? ☐ Yes ☐ No

11 Type of funding entity:
(a) ☐ Trust (benefits provided in whole from trust funds)
(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts
(c) ☒ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts
(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above
(e) ☐ Other (specify) ▶
(f) If (b) or (c) is checked, enter number of insurance carriers ▶ 1

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? ☐ Yes ☒ No
If "Yes," furnish the following information:

(a) Name	(b) Official plan position	(c) Relationship to employer, employee organization or person known to be a party-in-interest	(d) Gross salary or allowances paid by plan	(e) Fees and commissions paid by plan	(f) Nature of service provided to plan

16—69760-6

4-

	Yes	No
18 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?	X	
(b) If "Yes," enter the maximum amount of loss recoverable ▶ $ 400,000		
(c) Enter the name of the surety company ▶ Hartford Accident & Indemnity Company		
(d) Does the plan, or a known party-in-interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		X
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		X

19 Information about employees of employer at end of the plan year (do not complete for multiemployer plans):

(a) Total number of employees	
(b) Number of employees excluded from plan coverage—	
(i) Minimum age or years of service	
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining	
(iii) Nonresident aliens who receive no earned income from United States sources	
(iv) Other (specify) ▶	
(v) Total employees excluded, sum of (i) through (iv)	
(c) Total number of employees not excluded from the plan, (a) less (b)(v)	
(d) Total number of employees covered under the plan	

	Yes	No
20 Is this plan a master or prototype plan? If "Yes," enter IRS serial number ▶		
21 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code?		
(b) Have you requested or received a determination letter from the IRS for this plan?		
22 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
23 (a) Is this a defined benefit plan subject to the minimum funding standards? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards?		

If "Yes," complete (i), (ii) and (iii) below:

(i) Amount of employer contribution required for the plan year			
(ii) Amount of contribution paid by the employer for the plan year			
	Month	Day	Year
Enter date of last payment by employer, for this plan year			
(iii) Funding deficiency, excess, if any, of (i) over (ii)			

24 Pursuant to DOL regulations, financial statements, schedules and, in certain circumstances, an independent qualified public accountant's opinion thereon are required to be attached to the copy of this form filed with the DOL. With reference thereto, please check the appropriate boxes.

(a) The accountant's opinion is ☒ not required OR ☐ required and is—

(i) ☐ Unqualified

(ii) ☐ Qualified

(iii) ☐ Adverse

(iv) ☐ Other (explain) ▶

(b) The schedules included are—

(i) ☐ Investments at end of plan year

(ii) ☐ Transactions involving plan assets and a party known to be a party in interest

(iii) ☐ Loans by the plan or fixed income obligations due the plan in default or classified as uncollectable

(iv) ☐ Leases to which the plan was a party in default or classified as uncollectable

(v) ☐ Transactions or series of transactions in excess of 3% of the current value of plan assets

Note: *Failure to check a box indicates the plan has nothing to report for that item.*

If additional space is required for any item, attach additional sheets the same size as this form.

5-

SCHEDULE A (Form 5500)
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Insurance Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.
▶ Attach to Forms 5500, 5500–C, and 5500–K filed with DOL, if applicable.
▶ Do not file with IRS.

1975

This Form Is Open to Public Inspection

For plan year beginning June 21, 1975 and ending June 21, 19

▶ Part I must be completed for all plans required to file this schedule.
▶ Part II must be completed for all insured pension plans.
▶ Part III must be completed for all insured welfare plans.

▶ Please complete all applicable items on this Form. If an item does not apply, enter "NA".

Name of sponsor as shown on line 1(a) of Form 5500, 5500–C or 5500–K	Employer identification number
Domain Industries, Inc.	39-0501180
Name of plan	**Plan number**
Domain Industries, Inc. Travel Accident Insurance Plan	504

Part I Summary of All Insurance Contracts Included in Parts II and III
Group all contracts in the same manner as in Parts II and III.

1 Check appropriate box:
(a) ☒ Welfare plan (b) ☐ Pension plan (c) ☐ Combination pension and welfare plan

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year — Active: (b) Employees	(c) Dependents	Retired: (d) Employees	(e) Dependents	Policy/Contract Year: (f) From	(g) To
SR 40,370	375	-	-	-	6/21/75	6/21

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
SR 40,370	Wm. M. Mercer, Inc. 1515 Northwestern Bank Bldg. Minneapolis, MN 55402	411.30	N/A	Service & Consulta

4 Premiums due and unpaid at end of the plan year ▶ $, contract number, or identification ▶

Part II Insured Pension Plans
Provide information for each contract on a separate Part II. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

5 Contracts with allocated funds, for example, individual policies or group deferred annuity contracts:
(a) State the basis of premium rates ▶
(b) Total premiums paid to carrier
(c) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, enter amount
Specify nature of costs ▶

6 Contracts with unallocated funds, for example, deposit administration or immediate participation contract. Do not include portions of these contracts maintained in separate accounts:
(a) Balance at end of previous policy year
(b) Additions:
(i) Contributions deposited during year
(ii) Dividends and credits
(iii) Interest credited during year
(iv) Transferred from separate account
(v) Other (specify) ▶
(vi) Total additions
(c) Total of balance and additions, (a) plus (b)(vi)
(d) Deductions:
(i) Disbursed from fund to pay benefits or purchase annuities during year
(ii) Administration charge made by carrier
(iii) Transferred to separate account
(iv) Other (specify) ▶
(v) Total deductions
(e) Balance at end of current policy year, (c) less (d)(v)
7 Separate accounts: Current value of plan's interest in separate accounts at year end

5-

Insurance Information

This data is for your use in completion of Form 5500 – Schedule A and is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.

For plan year beginning 6/21, 1975 and ending 6/21, 1976

PART I Summary of Group Accident Insurance Contract(s) SR 40,370

1 Welfare plan Domain Industries, Inc.

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year: Active (b) Employees	Active (c) Dependents	Retired (d) Employees	Retired (e) Dependents	Policy/Contract Year (f) From	Policy/Contract Year (g) To
SR 40,370	Unknown	N/A	N/A	N/A	6/75	6/76

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
SR 40,370	Wm. M. Mercer, Inc. 1515 Northwestern Bank Bldg. Minneapolis, Minn. 55402	$411.30	N/A	Service & Consultat:

4 Premiums due and unpaid at end of the plan year ▶ $, contract number, or identification ▶

PART II Insured Welfare Plans

5 (a) Contract number or identification	(b) Type of benefit	(c) List gross premium for each contract	(d) Premium rate or subscription charge
SR 40,370	AD & D	$2,742	exposure rated

6 Experience rated contracts:

(a) Premiums:

(i) Amount received	N/A	
(ii) Increase (decrease) in amount due but unpaid	N/A	
(iii) Increase (decrease) in unearned premium reserve	N/A	
(iv) Premiums earned, (i) plus (ii), minus (iii)		N/A
(b) Benefit charges:		
(i) Claims paid	N/A	
(ii) Increase (decrease) in claim reserves	N/A	
(iii) Incurred Claims (i) plus (ii)		N/A
(iv) Claims charged		N/A
(c) Remainder of premium:		
(i) Retention charges (on an accrual basis)–		
(A) Commissions	N/A	
(B) Administrative service or other fees	N/A	
(C) Other specific acquisition costs	N/A	
(D) Other expenses	N/A	
(E) Taxes	N/A	
(F) Charges for risks or contingencies	N/A	
(G) Other retention charges	N/A	
(H) Total retention		N/A
(ii) Dividends or retroactive rate refunds. (Such amounts were ☐ paid in cash or ☐ credited.)		N/A
(d) Status of policyholder reserves at end of year:		
(i) Amount held to provide benefits after retirement		N/A
(ii) Claim reserves		N/A
(iii) Other reserves		N/A
(e) Dividends or retroactive rate refunds due (do not include amount entered in (c) (ii))		N/A

7 Non experience rated contracts:

(a) Total premiums or subscription charges paid to carrier .... N/A

(b) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, report amount .... N/A

Specify nature of costs ▶

If additional space is required for any item, attach additional sheets the same size as this form.

RIS-9920 ED. 12-76   5/26/77   Maggie Bellesorte, Supervisor - Reliance Insurance Co.

1-

July 15, 1977

To: All Participants Under The Domain Industries, Inc. Group Health Insurance Plan.

In accordance with the requirements of the Employee Retirement Income Security Act of 1974, you are being provided with this copy of the annual report form filed with respect to the Domain Industries, Inc. Group Health Insurance Plan for its year ending May 31, 1976.

Plan participants may obtain copies of the following more detailed annual report information for a reasonable charge or inspect without charge: the latest full annual report including a list of certain party-in-interest transactions. To obtain a copy of any documents listed, write to the administrator asking for exactly what you want. The administrator will state the charge for specific documents on request, so that you can find out the cost before ordering. All the documents listed can be examined at the General Office of Domain Industries, Inc.

The name, address, and telephone number of the plan administrator are:

Domain Industries, Inc.
c/o Jack Kilby
215 N. Knowles Avenue
New Richmond, WI 54017
(715) 246-6511

DOMAIN INDUSTRIES, INC.

2-

Form **5500**

Department of the Treasury
Internal Revenue Service
Department of Labor
Labor Management Services Administration

Annual Return/Report of Employee Benefit Plan (With 100 or more participants)

This form is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 and section 6058(a) of the Internal Revenue Code, referred to as the Code.

1975

This Form is Open to Public Inspection

Government use only ▶ |A| |B| |C| |D| |E| |F| |G| |H|

For the calendar plan year 1975 or fiscal plan year beginning June 1, 1975 and ending May 31, 1976

▶ All pension benefit plans with 100 or more participants file one copy of this form with the Department of Labor (DOL) and one copy with the Internal Revenue Service (IRS). File a separate form for each plan. Legible reproduction copies are acceptable.
▶ Welfare benefit plans with 100 or more participants file this form with DOL only.
▶ Pension benefit plans complete all items. However, annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 6, 9 and 10.
▶ Welfare benefit plans complete only items 1 through 18 and item 24.
▶ Note: *Do not file this form for:*
▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner-employee participant. File Form 5500-K instead.
▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants. File Form 5500-C instead.
▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of sponsor (employer if for a single employer plan) Domain Industries, Inc.	1 (b) Employer identification number 39-0501180
Address (number and street) 215 N. Knowles Avenue	1 (c) Telephone number (715) 246-6511
City or town, State and ZIP code New Richmond, Wisconsin 54017	1 (d) Employer taxable year ends January 31, 1976
2 (a) Name of plan administrator (if other than sponsor) Same as sponsor	1 (e) Business code number 2040
Address (number and street)	2 (b) Administrator's employer identification no.
City, town, State and ZIP code	2 (c) Telephone number ( )

3 Name, address and identification number of ☐ sponsor and/or ☐ plan administrator as they appeared on the last report filed with DOL or IRS if not the same as in 1 or 2 ▶ ....

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☒ Single-employer plan
(b) ☐ Plan of controlled group of corporations or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple employer-collectively-bargained plan
(e) ☐ Multiple employer plan (other)

5 (a) Name of plan: Domain Industries, Inc. Group Health Insurance Plan | 5 (b) Plan number: 5 0 1

6 Check at least one item in (a) or (b) and applicable items in (c):
(a) Welfare benefit plan: (i) ☒ Health insurance (ii) ☐ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☐ Other (specify) ▶ ....
(b) Pension benefit plan:
(i) Defined benefit plan—(indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶ ....
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit-sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ Other money purchase
(E) ☐ Other (specify) ▶ ....
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization or a governmental unit (section 403(b) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶ ....
(c) Other plan features:
(i) ☐ Thrift-savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

6/23/77 .... C. J. Mil[illegible]
Date — Signature of (employer) sponsor

....
Date — Signature of plan administrator

16—85758-1

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Form 5500 (1975) Page 2

7 Number of active and retired participants and beneficiaries as of the end of the plan year (welfare plans complete only (a)(iii), (b), (c) and (d)):

(a) Active participants (employed or carried as active) (i) Number fully vested	
(ii) Number not fully vested	
(iii) Total	802
(b) Retired participants receiving benefits	1
(c) Participants separated from employment and entitled to future benefits	-
(d) Subtotal, sum of (a), (b) and (c)	803
(e) Beneficiaries receiving pension benefits	
(f) Total, (d) plus (e)	

	Yes	No
(g) Has the number of active participants decreased at any time during the current year by more than 20% from the number of those participating at the beginning of the plan year?		
(h) Has the number of active participants decreased at any time during the current year by more than 25% from the number of those participating at the beginning of the previous plan year?		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was the plan amended in this plan year?		X
(b) If "Yes," (i) Has a Form EBS–1 reflecting the amendment been filed with DOL?		
(ii) Have the accrued benefits of any participant under the plan been reduced?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS?		

	Month	Day	Year
(c) Enter the date the most recent amendment was adopted	01	01	74

	Yes	No
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during the year?		X
(b) If "Yes," were all trust assets distributed?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		X
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		
10 (a) In this plan year, was this plan merged or consolidated with another plan or were assets or liabilities transferred to another plan?		X

If "Yes," enter information about other plan(s):

(b) Name of plan(s)	(c) Employer identification number(s)	(d) Plan number(s)

(e) Has actuarial statement been filed with IRS as required for defined benefit plans? ☐ Yes ☐ No

11 Type of funding entity:
(a) ☐ Trust (benefits provided in whole from trust funds)
(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts
(c) ☒ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts
(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above
(e) ☐ Other (specify) ▶
(f) If (b) or (c) is checked, enter number of insurance carriers ▶ 1

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? ☐ Yes ☒ No

If "Yes," furnish the following information:

(a) Name	(b) Official plan position	(c) Relationship to employer, employee organization or person known to be a party-in-interest	(d) Gross salary or allowances paid by plan	(e) Fees and commissions paid by plan	(f) Nature of service provided to plan

16—80165-6

	Yes	No
18 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?	X	
(b) If "Yes," enter the maximum amount of loss recoverable ▶ $ 400,000		
(c) Enter the name of the surety company ▶ Hartford Accident & Indemnity Company		
(d) Does the plan, or a known party-in-interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		X
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		X

19 Information about employees of employer at end of the plan year (do not complete for multiemployer plans):

(a) Total number of employees

(b) Number of employees excluded from plan coverage—

(i) Minimum age or years of service

(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining

(iii) Nonresident aliens who receive no earned income from United States sources

(iv) Other (specify) ▶

(v) Total employees excluded, sum of (i) through (iv)

(c) Total number of employees not excluded from the plan, (a) less (b)(v)

(d) Total number of employees covered under the plan

	Yes	No
20 Is this plan a master or prototype plan? If "Yes," enter IRS serial number ▶		
21 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code?		
(b) Have you requested or received a determination letter from the IRS for this plan?		
22 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
23 (a) Is this a defined benefit plan subject to the minimum funding standards? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards?		

If "Yes," complete (i), (ii) and (iii) below:

(i) Amount of employer contribution required for the plan year

(ii) Amount of contribution paid by the employer for the plan year

Enter date of last payment by employer, for this plan year — Month | Day | Year

(iii) Funding deficiency, excess, if any, of (i) over (ii)

24 Pursuant to DOL regulations, financial statements, schedules and, in certain circumstances, an independent qualified public accountant's opinion thereon are required to be attached to the copy of this form filed with the DOL. With reference thereto, please check the appropriate boxes:

(a) The accountant's opinion is ☒ not required OR ☐ required and is—

(i) ☐ Unqualified

(ii) ☐ Qualified

(iii) ☐ Adverse

(iv) ☐ Other (explain) ▶

(b) The schedules included are—

(i) ☐ Investments at end of plan year

(ii) ☐ Transactions involving plan assets and a party known to be a party-in-interest

(iii) ☐ Loans by the plan or fixed income obligations due the plan in default or classified as uncollectable

(iv) ☐ Leases to which the plan was a party in default or classified as uncollectable

(v) ☐ Transactions or series of transactions in excess of 3% of the current value of plan assets

Note: Failure to check a box indicates the plan has nothing to report for that item.

If additional space is required for any item, attach additional sheets the same size as this form.

5-

SCHEDULE A (Form 5500)
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Insurance Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.
▶ Attach to Forms 5500, 5500-C, and 5500-K filed with DOL, if applicable.
▶ Do not file with IRS.

1975
This Form Is Open to Public Inspection

For plan year beginning June 1, 1975 and ending May 31, 1976

▶ Part I must be completed for all plans required to file this schedule.
▶ Part II must be completed for all insured pension plans.
▶ Part III must be completed for all insured welfare plans.
▶ Please complete all applicable items on this Form. If an item does not apply, enter "NA".

Name of sponsor as shown on line 1(a) of Form 5500, 5500-C or 5500-K: Domain Industries, Inc.
Employer identification number: 39-0501180
Name of plan: Domain Industries, Inc. Group Health Insurance Plan
Plan number: 501

Part I Summary of All Insurance Contracts Included in Parts II and III
Group all contracts in the same manner as in Parts II and III.

1 Check appropriate box:
(a) [X] Welfare plan (b) [ ] Pension plan (c) [ ] Combination pension and welfare plan

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year — Active: (b) Employees	Active: (c) Dependents	Retired: (d) Employees	Retired: (e) Dependents	Policy/Contract Year: (f) From	(g) To
0174-07-053830	755	1633	1	0	6/1/75	5/31/76
0172-02-053830	214	293	0	0	6/1/75	5/31/76

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
	NONE			

4 Premiums due and unpaid at end of the plan year ▶ $ NONE, contract number, or identification ▶

Part II Insured Pension Plans
Provide information for each contract on a separate Part II. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

5 Contracts with allocated funds, for example, individual policies or group deferred annuity contracts:
(a) State the basis of premium rates ▶
(b) Total premiums paid to carrier
(c) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, enter amount
Specify nature of costs ▶

6 Contracts with unallocated funds, for example, deposit administration or immediate participation contract. Do not include portions of these contracts maintained in separate accounts:
(a) Balance at end of previous policy year
(b) Additions:
(i) Contributions deposited during year
(ii) Dividends and credits
(iii) Interest credited during year
(iv) Transferred from separate account
(v) Other (specify) ▶
(vi) Total additions
(c) Total of balance and additions, (a) plus (b)(vi)
(d) Deductions:
(i) Disbursed from fund to pay benefits or purchase annuities during year
(ii) Administration charge made by carrier
(iii) Transferred to separate account
(iv) Other (specify) ▶
(v) Total deductions
(e) Balance at end of current policy year, (c) less (d)(v)

7 Separate accounts: Current value of plan's interest in separate accounts at year end

6-

Part III—Schedule A, Form 5500
EMPLOYEE RETIREMENT INCOME SECURITY ACT DATA

This information must be furnished and certified to the administrator by the insurance carrier or service or other organization and should be for the period covered by the annual report. If the information is not available for that period, information for the latest completed policy year ending within the Plan year may be provided.

1. Name of sponsor ..... Domain Industries Inc. ....
2. a. Contract identification (or Number) ...... 0172-02-053830 ....
   b. Data for period: From .... 6-1-75 .... To .... 6-1-76 ....
3. Benefits and Coverage

BENEFITS PROVIDED (a)	APPROXIMATE NUMBER OF PERSONS COVERED BY EACH BENEFIT — ACTIVE — Employees (b)	ACTIVE — Dependents (c)	RETIRED — Employees (d)	RETIRED — Dependents (e)
Health Benefits — Fabric.	214	293		

Part III Insured Welfare Plans
Provide information for each contract on a separate Part III. If more than one contract covers the same group of employees of the same employer(s) or members of the same employee organization(s), the information may be combined for reporting purposes if such contracts are experience-rated as a unit. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

9 Experience rated contracts:		
(a) Premiums:		
(i) Amount received	47,705.00	
(ii) Increase (decrease) in amount due but unpaid	none	
(iii) Increase (decrease) in unearned premium reserve	none	
(iv) Premiums earned, (i) plus (ii), minus (iii)		47,705.00
(b) Benefit charges:		
(i) Claims paid	85,198.00	
(ii) Increase (decrease) in claim reserves	(12,729.00)	
(iii) Incurred claims (i) plus (ii)		72,469.00
(iv) Claims charged		72,469.00
(c) Remainder of premium:	Account acquired by a salaried employee	
(i) Retention charges (on an accrual basis)—		
(A) Commissions		
(B) Administrative service or other fees	none	
(C) Other specific acquisition costs	none	
(D) Other expenses	2,957.00	
(E) Taxes	191.00	
(F) Charges for risks or contingencies	969.00	
(G) Other retention charges	2,174.00	
(H) Total retention		6,291.00
(ii) Dividends or retroactive rate refunds. (Such amounts were ☐ paid in cash or ☐ credited.)		none
(d) Status of policyholder reserves at end of year:		
(i) Amount held to provide benefits after retirement		none
(ii) Claim reserves		12,549.00
(iii) Other reserves		none
(e) Dividends or retroactive rate refunds due (do not include amount entered in (c)(ii))		none

Certified: ☒ Employers Mutual Liability Insurance Company of Wisconsin
☐ Employers Life Insurance Company of Wausau
☐ Illinois Employers Insurance of Wausau

1,040.00 Received from life policies 0172-06-053830 and 0172-05-053830 to reduce retrospective surcharge.

By R. J. Wendorff
Secretary

Policies 0172-02-053830, 0174-07-053830, 0175-08-053830, 0172-05-053830 and 0172-06-053830 are combined for retrospective premium computation or premium refund.

7718-3420 10-76 PRTD. USA

I-

Part III—Schedule A, Form 5500
EMPLOYEE RETIREMENT INCOME SECURITY ACT DATA

This information must be furnished and certified to the administrator by the insurance carrier or service or other organization and should be for the period covered by the annual report. If the information is not available for that period, information for the latest completed policy year ending within the Plan year may be provided.

1. Name of sponsor ....Domain Industries Inc...

2. a --Contract identification (or Number) ......0174-07-053830...

   b. Data for period: From ......6-1-75........................... To......6-1-76......................

3 Benefits and Coverage

BENEFITS PROVIDED (a)	APPROXIMATE NUMBER OF PERSONS COVERED BY EACH BENEFIT — ACTIVE — Employees (b)	ACTIVE — Dependents (c)	RETIRED — Employees (d)	RETIRED — Dependents (e)
Health Benefits - all Full	755	1633	1	---

Part III Insured Welfare Plans

Provide information for each contract on a separate Part III. If more than one contract covers the same group of employees of the same employer(s) or members of the same employee organization(s), the information may be combined for reporting purposes if such contracts are experience-rated as a unit. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

9 Experience rated contracts:		
(a) Premiums:		
(i) Amount received	416,075.00	
(ii) Increase (decrease) in amount due but unpaid	none	
(iii) Increase (decrease) in unearned premium reserve	none	
(iv) Premiums earned, (i) plus (ii), minus (iii)		416,075.00
(b) Benefit charges:		
(i) Claims paid	329,854.00	
(ii) Increase (decrease) in claim reserves	32,160.00	
(iii) Incurred claims (i) plus (ii)		362,014.00
(iv) Claims charged		362,014.00
(c) Remainder of premium:	Account acquired by a	
(i) Retention charges (on an accrual basis)—	salaried employee	
(A) Commissions		
(B) Administrative service or other fees	none	
(C) Other specific acquisition costs	none	
(D) Other expenses	25,792.00	
(E) Taxes	1,670.00	
(F) Charges for risks or contingencies	8,455.00	
(G) Other retention charges	10,860.00	
(H) Total retention		46,777.00
(ii) Dividends or retroactive rate refunds (Such amounts were ☐ paid in cash or ☐ credited.)		none
(d) Status of policyholder reserves at end of year:		
(i) Amount held to provide benefits after retirement		none
(ii) Claim reserves		135,441.00
(iii) Other reserves		none
(e) Dividends or retroactive rate refunds due (do not include amount entered in (c)(ii))		none

Certified: ☒ Employers Mutual Liability Insurance Company of Wisconsin
☐ Employers Life Insurance Company of Wausau
☐ Illinois Employers Insurance of Wausau

By R. J. Wendorff

$9,075.00 received from life policies 0172-06-053830 and 0172-05-053830 to reduce retrospective surcharge.

Policies 0172-02-053830, 0174-07-053830, 0175-08-053830, 0172-05-053830 and 0172-06-053830 are combined for retrospective premium computation or premium refund.

7715-3429 10-76 PRTD. USA

Bill McKeon 1.

July 15, 1977

To: All Participants Under The Domain Industries, Inc. Group Supplemental Life Plan.

In accordance with the requirements of the Employee Retirement Income Security Act of 1974, you are being provided with this copy of the annual report form filed with respect to the Domain Industries, Inc. Group Supplemental Life Plan for its year ending May 31, 1976.

Plan participants may obtain copies of the following more detailed annual report information for a reasonable charge or inspect without charge: the latest full annual report including a list of certain party-in-interest transactions. To obtain a copy of any documents listed, write to the administrator asking for exactly what you want. The administrator will state the charge for specific documents on request, so that you can find out the cost before ordering. All the documents listed can be examined at the General Office of Domain Industries, Inc.

The name, address, and telephone number of the plan administrator are:

Domain Industries, Inc.
c/o Jack Kilby
215 ~~N.~~ Knowles Avenue
New Richmond, WI 54017
(715) 246-6511

DOMAIN INDUSTRIES, INC.

2-

Form **5500**
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Annual Return/Report of Employee Benefit Plan (With 100 or more participants)

This form is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 and section 6058(a) of the Internal Revenue Code, referred to as the Code.

1975
This Form is Open to Public Inspection

Government use only ▶ A | B | C | D | E | F | G | H

For the calendar plan year 1975 or fiscal plan year beginning June 1, 1975 and ending May 31, 1976

▶ All pension benefit plans with 100 or more participants file one copy of this form with the Department of Labor (DOL) and one copy with the Internal Revenue Service (IRS). File a separate form for each plan. Legible reproduction copies are acceptable.
▶ Welfare benefit plans with 100 or more participants file this form with DOL only.
▶ Pension benefit plans complete all items. However, annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 6, 9 and 10.
▶ Welfare benefit plans complete only items 1 through 18 and item 24.
▶ Note: *Do not file this form for:*
▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner employee participant. File Form 5500-K instead.
▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants. File Form 5500-C instead.
▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of sponsor (employer if for a single employer plan): Domain Industries, Inc.
Address (number and street): 215 N. Knowles Avenue
City or town, State and ZIP code: New Richmond, Wisconsin 54017

1 (b) Employer identification number: 39-0501180
1 (c) Telephone number: (715) 246-6511
1 (d) Employer taxable year ends: January 31, 1976
1 (e) Business code number: 2040

2 (a) Name of plan administrator (if other than sponsor): Same as sponsor
Address (number and street):
City, town, State and ZIP code:

2 (b) Administrator's employer identification no.:
2 (c) Telephone number: ( )

3 Name, address and identification number of ☐ sponsor and/or ☐ plan administrator as they appeared on the last report filed with DOL or IRS if not the same as in 1 or 2 ▶ ....

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☒ Single-employer plan
(b) ☐ Plan of controlled group of corporations or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple-employer-collectively bargained plan
(e) ☐ Multiple employer plan (other)

5 (a) Name of plan: Domain Industries, Inc. Group Supplemental Life Plan
5 (b) Plan number: 5 0 5

6 Check at least one item in (a) or (b) and applicable items in (c):
(a) Welfare benefit plan: (i) ☐ Health insurance (ii) ☒ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☐ Other (specify) ▶ ....
(b) Pension benefit plan:
(i) Defined benefit plan—(Indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶ ....
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit-sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ Other money purchase
(E) ☐ Other (specify) ▶ ....
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization or a governmental unit (section 403(b) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶ ....
(c) Other plan features:
(i) ☐ Thrift-savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

6/28/77 .... W.D. Mil[illegible] ....
Date — Signature of employer/sponsor

....
Date — Signature of plan administrator

Form 5500 (1975) Page 2

7 Number of active and retired participants and beneficiaries as of the end of the plan year (welfare plans complete only (a)(iii), (b), (c) and (d))

(a) Active participants (employed or carried as active) (i) Number fully vested . . ____

(ii) Number not fully vested . ____

(iii) Total 121

(b) Retired participants receiving benefits . . . . -

(c) Participants separated from employment and entitled to future benefits . . . . -

(d) Subtotal, sum of (a), (b) and (c) 121

(e) Beneficiaries receiving pension benefits . . . . ____

(f) Total, (d) plus (e) . . . . ____

	Yes	No
(g) Has the number of active participants decreased at any time during the current year by more than 20% from the number of those participating at the beginning of the plan year?		
(h) Has the number of active participants decreased at any time during the current year by more than 25% from the number of those participating at the beginning of the previous plan year?		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was the plan amended in this plan year?		X
(b) If "Yes," (i) Has a Form EBS-1 reflecting the amendment been filed with DOL?		
(ii) Have the accrued benefits of any participant under the plan been reduced?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS?		

	Month	Day	Year
(c) Enter the date the most recent amendment was adopted	03	01	72

	Yes	No
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during the year?		X
(b) If "Yes," were all trust assets distributed?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		X
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		
10 (a) In this plan year, was this plan merged or consolidated with another plan or were assets or liabilities transferred to another plan?		X

If "Yes," enter information about other plan(s):	(c) Employer identification number(s)	(d) Plan number(s)
(b) Name of plan(s) ▶		

(e) Has actuarial statement been filed with IRS as required for defined benefit plans? . . . ☐ Yes ☐ No

11 Type of funding entity:

(a) ☐ Trust (benefits provided in whole from trust funds)

(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts

(c) ☒ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts

(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above

(e) ☐ Other (specify) ▶

(f) If (b) or (c) is checked, enter number of insurance carriers . . . . ▶ 1

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? . . . . ☐ Yes ☒ No

If "Yes," furnish the following information:

(a) Name	(b) Official plan position	(c) Relationship to employer, employee organization or person known to be a party-in-interest	(d) Gross salary or allowances paid by plan	(e) Fees and commissions paid by plan	(f) Nature of service provided to plan

	Yes	No
18 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?	X	
(b) If "Yes," enter the maximum amount of loss recoverable ▶ $ 400,000		
(c) Enter the name of the surety company ▶ Hartford Accident & Indemnity Company		
(d) Does the plan, or a known party in interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		X
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		X

19 Information about employees of employer at end of the plan year (do not complete for multiemployer plans):

(a) Total number of employees	
(b) Number of employees excluded from plan coverage—	
(i) Minimum age or years of service	
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining	
(iii) Nonresident aliens who receive no earned income from United States sources	
(iv) Other (specify) ▶	
(v) Total employees excluded, sum of (i) through (iv)	
(c) Total number of employees not excluded from the plan, (a) less (b)(v)	
(d) Total number of employees covered under the plan	

	Yes	No
20 Is this plan a master or prototype plan? If "Yes," enter IRS serial number ▶		
21 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code?		
(b) Have you requested or received a determination letter from the IRS for this plan?		
22 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
23 (a) Is this a defined benefit plan subject to the minimum funding standards? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards?		

If "Yes," complete (i), (ii) and (iii) below:

(i) Amount of employer contribution required for the plan year			
(ii) Amount of contribution paid by the employer for the plan year			
	Month	Day	Year
Enter date of last payment by employer, for this plan year			
(iii) Funding deficiency, excess, if any, of (i) over (ii)			

24 Pursuant to DOL regulations, financial statements, schedules and, in certain circumstances, an independent qualified public accountant's opinion thereon are required to be attached to the copy of this form filed with the DOL. With reference thereto, please check the appropriate boxes:

(a) The accountant's opinion is ☒ not required OR ☐ required and is—
- (i) ☐ Unqualified
- (ii) ☐ Qualified
- (iii) ☐ Adverse
- (iv) ☐ Other (explain) ▶

(b) The schedules included are—
- (i) ☐ Investments at end of plan year
- (ii) ☐ Transactions involving plan assets and a party known to be a party-in-interest
- (iii) ☐ Loans by the plan or fixed income obligations due the plan in default or classified as uncollectable
- (iv) ☐ Leases to which the plan was a party in default or classified as uncollectable
- (v) ☐ Transactions or series of transactions in excess of 3% of the current value of plan assets

Note: Failure to check a box indicates the plan has nothing to report for that item.

If additional space is required for any item, attach additional sheets the same size as this form.

SCHEDULE A (Form 5500)
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Insurance Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.
▶ Attach to Forms 5500, 5500-C, and 5500-K filed with DOL, if applicable.
▶ Do not file with IRS.

1975

This Form I Open to Pub. Inspection

For plan year beginning June 1, 19 75 and ending May 31, 19

▶ Part I must be completed for all plans required to file this schedule.
▶ Part II must be completed for all insured pension plans.
▶ Part III must be completed for all insured welfare plans.

▶ Please complete all applicable items on this F. If an item does not apply, enter "NA".

Name of sponsor as shown on line 1(a) of Form 5500, 5500-C or 5500-K: Domain Industries, Inc.
Employer identification number: 39-0501180

Name of plan: Domain Industries, Inc. Group Supplemental Life Plan
Plan number: 505

Part I Summary of All Insurance Contracts Included in Parts II and III
Group all contracts in the same manner as in Parts II and III.

1 Check appropriate box:
(a) ☒ Welfare plan (b) ☐ Pension plan (c) ☐ Combination pension and welfare plan

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year — Active: (b) Employees	Active: (c) Dependents	Retired: (d) Employees	Retired: (e) Dependents	Policy/Contract Year: (f) From	(g)
0172-06-053830	121	-	-	-	6/1/75	5/3

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
—	NONE			

4 Premiums due and unpaid at end of the plan year ▶ $ NONE, contract number, or identification ▶

Part II Insured Pension Plans
Provide information for each contract on a separate Part II. Where individual contracts are provided, the entire gr of such individual contracts with each carrier may be treated as a unit for purposes of this report.

5 Contracts with allocated funds, for example, individual policies or group deferred annuity contracts:
(a) State the basis of premium rates ▶
(b) Total premiums paid to carrier
(c) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, enter amount
Specify nature of costs ▶

6 Contracts with unallocated funds, for example, deposit administration or immediate participation contract. Do not include portions of these contracts maintained in separate accounts:
(a) Balance at end of previous policy year
(b) Additions:
(i) Contributions deposited during year
(ii) Dividends and credits
(iii) Interest credited during year
(iv) Transferred from separate account
(v) Other (specify) ▶
(vi) Total additions
(c) Total of balance and additions, (a) plus (b)(vi)
(d) Deductions:
(i) Disbursed from fund to pay benefits or purchase annuities during year
(ii) Administration charge made by carrier
(iii) Transferred to separate account
(iv) Other (specify) ▶
(v) Total deductions
(e) Balance at end of current policy year, (c) less (d)(v)

7 Separate accounts: Current value of plan's interest in separate accounts at year end

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Part III—Schedule A, Form 5500
EMPLOYEE RETIREMENT INCOME SECURITY ACT DATA

This information must be furnished and certified to the administrator by the insurance carrier or service or other organization and should be for the period covered by the annual report. If the information is not available for that period, information for the latest completed policy year ending within the Plan year may be provided.

1. Name of sponsor .... Domain Industries Inc. ....
2. a. Contract identification (or Number) ... 0172-06-053830 ....
   b. Data for period: From .... 6-1-75 .... To ..... 6-1-76 ....
3. Benefits and Coverage

BENEFITS PROVIDED (a)	APPROXIMATE NUMBER OF PERSONS COVERED BY EACH BENEFIT			
	ACTIVE		RETIRED	
	Employees (b)	Dependents (c)	Employees (d)	Dependents (e)
Life Benefits — Supp. Life	121	----		

Part III Insured Welfare Plans
Provide information for each contract on a separate Part III. If more than one contract covers the same group of employees of the same employer(s) or members of the same employee organization(s), the information may be combined for reporting purposes if such contracts are experience rated as a unit. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

9 Experience rated contracts:		
(a) Premiums:		
(i) Amount received	10,519.00	
(ii) Increase (decrease) in amount due but unpaid	none	
(iii) Increase (decrease) in unearned premium reserve	none	
(iv) Premiums earned, (i) plus (ii), minus (iii)		10,519.00
(b) Benefit charges:		
(i) Claims paid	1,078.00	
(ii) Increase (decrease) in claim reserves	9,940.00	
(iii) Incurred claims (i) plus (ii)		11,018.00
(iv) Claims charged		7,981.00
(c) Remainder of premium:	Account acquired by a salaried employee	
(i) Retention charges (on an accrual basis)—		
(A) Commissions	none	
(B) Administrative service or other fees	none	
(C) Other specific acquisition costs	592.00	
(D) Other expenses	189.00	
(E) Taxes	173.00	
(F) Charges for risks or contingencies		
(G) Other retention charges	(3,037.00)	
(H) Total retention		(2,083.00)
(ii) Dividends or retroactive rate refunds. (Such amounts were ☐ paid in cash or ☒ credited.)		1,209.00*
(d) Status of policyholder reserves at end of year:		
(i) Amount held to provide benefits after retirement		none
(ii) Claim reserves		none
(iii) Other reserves		1,463.00
(e) Dividends or retroactive rate refunds due (do not include amount entered in (c)(ii))		none

Certified: ☐ Employers Mutual Liability Insurance Company of Wisconsin
☒ Employers Life Insurance Company of Wausau
☐ Illinois Employers Insurance of Wausau

By R. J. Wendorff
Secretary

*$1,209.00 transferred to health policies 0172-02-053830, 0174-07-053830, and 0175-08-053830.

Policies 0172-02-053830, 0174-07-053830, 0175-08-053830, 0172-05-053830 and 0172-06-053830 are combined for retrospective premium computation or premium refund.

1-

July 15, 1977

To: All Participants Under The Domain Industries, Inc. Group Life Insurance Plan.

In accordance with the requirements of the Employee Retirement Income Security Act of 1974, you are being provided with this copy of the annual report form filed with respect to the Domain Industries, Inc. Group Life Insurance Plan for its year ending May 31, 1976.

Plan participants may obtain copies of the following more detailed annual report information for a reasonable charge or inspect without charge: the latest full annual report including a list of certain party-in-interest transactions. To obtain a copy of any documents listed, write to the administrator asking for exactly what you want. The administrator will state the charge for specific documents on request, so that you can find out the cost before ordering. All the documents listed can be examined at the General Office of Domain Industries, Inc.

The name, address, and telephone number of the plan administrator are:

Domain Industries, Inc.
c/o Jack Kilby
215 N. Knowles Avenue
New Richmond, WI 54017
(715) 246-6511

DOMAIN INDUSTRIES, INC.

2-

Form 5500
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Annual Return/Report of Employee Benefit Plan (With 100 or more participants)

This form is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974 and section 6058(a) of the Internal Revenue Code, referred to as the Code.

1975
This Form is Open to Public Inspection

Government use only ▶ A | B | C | D | E | F | G | H

For the calendar plan year 1975 or fiscal plan year beginning June 1, 1975 and ending May 31, 1976

▶ All pension benefit plans with 100 or more participants file one copy of this form with the Department of Labor (DOL) and one copy with the Internal Revenue Service (IRS). File a separate form for each plan. Legible reproduction copies are acceptable.
▶ Welfare benefit plans with 100 or more participants file this form with DOL only.
▶ Pension benefit plans complete all items. However, annuity arrangements of certain exempt organizations and individual retirement account trusts of employers complete only items 1 through 6, 9 and 10.
▶ Welfare benefit plans complete only items 1 through 18 and item 24.
▶ Note: Do not file this form for:
▶ Keogh (H.R. 10) plans with fewer than 100 participants and with at least one owner-employee participant. File Form 5500-K instead.
▶ Other pension benefit plans and certain welfare benefit plans with fewer than 100 participants. File Form 5500-C instead.
▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of sponsor (employer if for a single employer plan)
Domain Industries, Inc.
Address (number and street)
215 N. Knowles Avenue
City or town, State and ZIP code
New Richmond, Wisconsin 54017

1 (b) Employer identification number
39-0501180
1 (c) Telephone number
(715) 246-6511
1 (d) Employer taxable year ends
January 31, 1976
1 (e) Business code number
2040

2 (a) Name of plan administrator (if other than sponsor)
Same as sponsor
Address (number and street)

City, town, State and ZIP code

2 (b) Administrator's employer identification no.
2 (c) Telephone number
(   )

3 Name, address and identification number of ☐ sponsor and/or ☐ plan administrator as they appeared on the last report filed with DOL or IRS if not the same as in 1 or 2 ▶

4 Check appropriate box to indicate the type of plan entity (check only one box):
(a) ☒ Single-employer plan
(b) ☐ Plan of controlled group of corporations or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple employer-collectively bargained plan
(e) ☐ Multiple employer plan (other)

5 (a) Name of plan:
Domain Industries, Inc. Group Life Insurance Plan
5 (b) Plan number: 5 0 2

6 Check at least one item in (a) or (b) and applicable items in (c):
(a) Welfare benefit plan: (i) ☐ Health insurance (ii) ☒ Life insurance (iii) ☐ Supplemental unemployment
(iv) ☐ Other (specify) ▶
(b) Pension benefit plan:
(i) Defined benefit plan—(Indicate type of defined benefit plan below):
(A) ☐ Fixed benefit (B) ☐ Unit benefit (C) ☐ Flat benefit (D) ☐ Other (specify) ▶
(ii) Defined contribution plan—(indicate type of defined contribution plan below):
(A) ☐ Profit-sharing (B) ☐ Stock bonus (C) ☐ Target benefit (D) ☐ Other money purchase
(E) ☐ Other (specify) ▶
(iii) ☐ Defined benefit plan with benefits based partly on balance of separate account of participant (section 414(k) of the Code)
(iv) ☐ Annuity arrangement of a certain exempt organization or a governmental unit (section 403(b) of the Code)
(v) ☐ Custodial account for regulated investment company stock (section 403(b)(7) of the Code)
(vi) ☐ Trust treated as an individual retirement account (section 408(c) of the Code)
(vii) ☐ Employee stock ownership plan not part of a qualified plan (section 301(d) of the Tax Reduction Act of 1975)
(viii) ☐ Other (specify) ▶
(c) Other plan features:
(i) ☐ Thrift savings (ii) ☐ Keogh (H.R. 10) plan
(iii) ☐ Employee stock ownership as part of a qualified plan (check only if you checked a box in (b)(ii) above)

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

6/25/77 [signature]
Date — Signature of (employer) sponsor

Date — Signature of plan administrator

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Form 5500 (1975) Page 2

7 Number of active and retired participants and beneficiaries as of the end of the plan year (welfare plans complete only (a)(iii), (b), (c) and (d)):

(a) Active participants (employees or carried as active) (i) Number fully vested	
(ii) Number not fully vested	
(iii) Total	754
(b) Retired participants receiving benefits	30
(c) Participants separated from employment and entitled to future benefits	-
(d) Subtotal, sum of (a), (b) and (c)	784
(e) Beneficiaries receiving pension benefits	
(f) Total, (d) plus (e)	

	Yes	No
(g) Has the number of active participants decreased at any time during the current year by more than 20% from the number of those participating at the beginning of the plan year?		
(h) Has the number of active participants decreased at any time during the current year by more than 25% from the number of those participating at the beginning of the previous plan year?		
8 Plan amendment information (welfare plans complete only (a), (b)(i) and (c)):		
(a) Was the plan amended in this plan year?		X
(b) If "Yes," (i) Has a Form EBS-1 reflecting the amendment been filed with DOL?		
(ii) Have the accrued benefits of any participant under the plan been reduced?		
(iii) Will amendment result in a reduction of current or future benefits?		
(iv) Has a determination letter been requested from IRS?		

(c) Enter the date the most recent amendment was adopted — Month 06, Day 01, Year 71

	Yes	No
9 Plan termination information (welfare plans complete only (a), (b), (c) and (f)):		
(a) Was this plan terminated during the year?		X
(b) If "Yes," were all trust assets distributed?		
(c) Was a resolution to terminate this plan adopted during this plan year or any prior plan year?		X
(d) If (a) or (c) is "Yes," have you received a favorable determination letter from IRS with respect to such termination?		
(e) If (d) is "No," has a determination letter been requested from IRS?		
(f) If (a) or (c) is "Yes," have participants and beneficiaries been notified of the termination or the proposed termination?		
10 (a) In this plan year, was this plan merged or consolidated with another plan or were assets or liabilities transferred to another plan?		X

If "Yes," enter information about other plan(s):

(b) Name of plan(s)	(c) Employer identification number(s)	(d) Plan number(s)

(e) Has actuarial statement been filed with IRS as required for defined benefit plans? ☐ Yes ☐ No

11 Type of funding entity:

(a) ☐ Trust (benefits provided in whole from trust funds)

(b) ☐ Trust or arrangement providing benefits partially through insurance and/or annuity contracts

(c) ☒ Trust or arrangement providing benefits exclusively through insurance and/or annuity contracts

(d) ☐ Custodial account described in section 401(f) of the Code and not included in (c) above

(e) ☐ Other (specify) ▶

(f) If (b) or (c) is checked, enter number of insurance carriers ▶ 1

12 Did any person who rendered services to the plan receive, directly or indirectly, compensation from the plan in the plan year? ☐ Yes ☒ No

If "Yes," furnish the following information:

(a) Name	(b) Official plan position	(c) Relationship to employer, employee organization or person known to be a party-in-interest	(d) Gross salary or allowances paid by plan	(e) Fees and commissions paid by plan	(f) Nature of service provided to plan

Form 5500 (1975) Page 5

	Yes	No
18 Bonding:		
(a) Was the plan insured by a fidelity bond against losses through fraud or dishonesty?	X	
(b) If "Yes," enter the maximum amount of loss recoverable ▶ $ 400,000		
(c) Enter the name of the surety company ▶ Hartford Accident & Indemnity Company		
(d) Does the plan, or a known party-in-interest with respect to the plan, have any control or significant financial interest, direct or indirect, in the surety company or its agents or brokers?		X
(e) If the plan is not insured by a fidelity bond, explain why not ▶		
(f) In the current plan year was any loss to the plan caused by the fraud or dishonesty of any plan official or employee of the plan or of other person handling funds of the plan? If "Yes," see specific instructions.		X

19 Information about employees of employer at end of the plan year (do not complete for multiemployer plans):

(a) Total number of employees
(b) Number of employees excluded from plan coverage—
(i) Minimum age or years of service
(ii) Employees on whose behalf retirement benefits were the subject of collective bargaining
(iii) Nonresident aliens who receive no earned income from United States sources
(iv) Other (specify) ▶
(v) Total employees excluded, sum of (i) through (iv)
(c) Total number of employees not excluded from the plan, (a) less (b)(v)
(d) Total number of employees covered under the plan

	Yes	No
20 Is this plan a master or prototype plan? If "Yes," enter IRS serial number ▶		
21 (a) Is it intended that this plan qualify under section 401(a) or 405 of the Code		
(b) Have you requested or received a determination letter from the IRS for this plan?		
22 If plan is integrated, check appropriate box: (a) ☐ Social security (b) ☐ Railroad retirement (c) ☐ Other		
23 (a) Is this a defined benefit plan subject to the minimum funding standards? If "Yes," attach Schedule B (Form 5500).		
(b) Is this a defined contribution plan, i.e., money purchase or target benefit, subject to the minimum funding standards?		

If "Yes," complete (i), (ii) and (iii) below:
(i) Amount of employer contribution required for the plan year
(ii) Amount of contribution paid by the employer for the plan year

Enter date of last payment by employer, for this plan year — Month | Day | Year

(iii) Funding deficiency, excess, if any, of (i) over (ii)

24 Pursuant to DOL regulations, financial statements, schedules and, in certain circumstances, an independent qualified public accountant's opinion thereon are required to be attached to the copy of this form filed with the DOL. With reference thereto, please check the appropriate boxes:

(a) The accountant's opinion is ☒ not required OR ☐ required and is—
(i) ☐ Unqualified
(ii) ☐ Qualified
(iii) ☐ Adverse
(iv) ☐ Other (explain) ▶

(b) The schedules included are—
(i) ☐ Investments at end of plan year
(ii) ☐ Transactions involving plan assets and a party known to be a party-in-interest
(iii) ☐ Loans by the plan or fixed income obligations due the plan in default or classified as uncollectable
(iv) ☐ Leases to which the plan was a party in default or classified as uncollectable
(v) ☐ Transactions or series of transactions in excess of 3% of the current value of plan assets

Note: *Failure to check a box indicates the plan has nothing to report for that item.*

If additional space is required for any item, attach additional sheets the same size as this form.

SCHEDULE A (Form 5500)
Department of the Treasury Internal Revenue Service
Department of Labor Labor Management Services Administration

Insurance Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA.
▶ Attach to Forms 5500, 5500–C, and 5500–K filed with DOL, if applicable.
▶ Do not file with IRS.

5-
1975
This Form Is Open to Public Inspection

For plan year beginning June 1, 19 75 and ending May 31, 1976

▶ Part I must be completed for all plans required to file this schedule.
▶ Part II must be completed for all insured pension plans.
▶ Part III must be completed for all insured welfare plans.

▶ Please complete all applicable items on this Form. If an item does not apply, enter "NA".

Name of sponsor as shown on line 1(a) of Form 5500, 5500–C or 5500–K: Domain Industries, Inc.
Employer identification number: 39-0501180

Name of plan: Domain Industries, Inc. Group Life Insurance Plan
Plan number: 502

Part I Summary of All Insurance Contracts Included in Parts II and III
Group all contracts in the same manner as in Parts II and III.

1 Check appropriate box:
(a) ☒ Welfare plan (b) ☐ Pension plan (c) ☐ Combination pension and welfare plan

2 Coverage:

(a) Contract number or identification	Approximate number of persons covered at end of policy or contract year — Active (b) Employees	Active (c) Dependents	Retired (d) Employees	Retired (e) Dependents	Policy/Contract Year (f) From	(g) To
0172-05-053830	771	0	30	-	6/1/75	5/31

3 Insurance fees and commissions paid to general agents, brokers or other persons:

(a) Contract number or identification	(b) Name and address of each recipient of fees or commissions	(c) Amount of commissions paid	(d) Amount of fees paid	(e) Purpose for which paid
	NONE			

4 Premiums due and unpaid at end of the plan year ▶ $ NONE, contract number, or identification ▶

Part II Insured Pension Plans
Provide information for each contract on a separate Part II. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

5 Contracts with allocated funds, for example, individual policies or group deferred annuity contracts:
(a) State the basis of premium rates ▶
(b) Total premiums paid to carrier
(c) If the carrier, service or other organization incurred any specific costs in connection with the acquisition or retention of the contract or policy, other than reported in 3 above, enter amount
Specify nature of costs ▶

6 Contracts with unallocated funds, for example, deposit administration or immediate participation contract. Do not include portions of these contracts maintained in separate accounts:
(a) Balance at end of previous policy year
(b) Additions:
(i) Contributions deposited during year
(ii) Dividends and credits
(iii) Interest credited during year
(iv) Transferred from separate account
(v) Other (specify) ▶
(vi) Total additions
(c) Total of balance and additions, (a) plus (b)(vi)
(d) Deductions:
(i) Disbursed from fund to pay benefits or purchase annuities during year
(ii) Administration charge made by carrier
(iii) Transferred to separate account
(iv) Other (specify) ▶
(v) Total deductions
(e) Balance at end of current policy year, (c) less (d)(v)
7 Separate accounts: Current value of plan's interest in separate accounts at year end

6-

Part III—Schedule A, Form 5500
EMPLOYEE RETIREMENT INCOME SECURITY ACT DATA

This information must be furnished and certified to the administrator by the insurance carrier or service or other organization and should be for the period covered by the annual report. If the information is not available for that period, information for the latest completed policy year ending within the Plan year may be provided.

1. Name of sponsor .... Domain Industries, Inc.
2. a. Contract identification (or Number) 0172-05-053830
   b Data for period: From ...... 6-1-75 .... To 6-1-76
3. Benefits and Coverage

BENEFITS PROVIDED (a)	APPROXIMATE NUMBER OF PERSONS COVERED BY EACH BENEFIT — ACTIVE: Employees (b)	ACTIVE: Dependents (c)	RETIRED: Employees (d)	RETIRED: Dependents (e)
Life Benefits	771	—	30	—

Part III Insured Welfare Plans
Provide information for each contract on a separate Part III. If more than one contract covers the same group of employees of the same employer(s) or members of the same employee organization(s), the information may be combined for reporting purposes if such contracts are experience-rated as a unit. Where individual contracts are provided, the entire group of such individual contracts with each carrier may be treated as a unit for purposes of this report.

9 Experience rated contracts:		
(a) Premiums:		
(i) Amount received	86,101.00	
(ii) Increase (decrease) in amount due but unpaid	none	
(iii) Increase (decrease) in unearned premium reserve	none	
(iv) Premiums earned, (i) plus (ii), minus (iii)		86,101.00
(b) Benefit charges:		
(i) Claims paid	54,500.00	
(ii) Increase (decrease) in claim reserves	7,062.00	
(iii) Incurred claims (i) plus (ii)		61,562.00
(iv) Claims charged		65,325.00
(c) Remainder of premium:		
(i) Retention charges (on an accrual basis)—		
(A) Commissions	Account acquired by a salaried employee	
(B) Administrative service or other fees	none	
(C) Other specific acquisition costs	none	
(D) Other expenses	4,846.00	
(E) Taxes	1,550.00	
(F) Charges for risks or contingencies	1,418.00	
(G) Other retention charges	3,763.00	
(H) Total retention		11,577.00
(ii) Dividends or retroactive rate refunds. (Such amounts were ☐ paid in cash or ☒ credited.)		9,900.00*
(d) Status of policyholder reserves at end of year:		
(i) Amount held to provide benefits after retirement		none
(ii) Claim reserves		none
(iii) Other reserves		11,972.00
(e) Dividends or retroactive rate refunds due (do not include amount entered in (c)(ii))		none

Certified ☐ Employers Mutual Liability Insurance Company of Wisconsin
☒ Employers Life Insurance Company of Wausau
☐ Illinois Employers Insurance of Wausau

*$9,900.00 transferred to health policies 0172-02-053830, 0174-07-053830 and 0175-08-053830.

By R. J. Wendorff

Policies 0172-02-053830, 0174-07-053830, 0175-08-053830, 0172-05-053830 and 0172-06-053830 are combined for retrospective premium computation or premium refund.

7718-3429 10-76 PRTD USA

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.,
New York, N.Y., June 28, 1977.

Re S. 285.

Hon. LLOYD M. BENTSEN, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BENTSEN: The ICAA was organized in 1937 and consists of more than 70 firms which are engaged primarily in rendering investment supervisory services on a continuous basis; are registered under the Investment Adviser Act of 1940; are entitled to use the term "investment counsel" under that Act, and receive no compensation based on the value or frequency of transactions.

Our association is particularly interested in two features of S. 285: (1) the 5 percent limit per class of security imposed on managers of over $1,000,000,000 of pension assets, and (2) the "modification" of the ERISA prudent man rule to permit investment of 2 percent of the assets of a pension plan in companies with paid-in capital of less than $25,000,000 or in venture capital funds which invest in such companies.

Our experience teaches us the vital importance of flexibility in investment: the ever changing investment climate may convert the apparent wisdom of today's limit to tomorrow's folly. We urge you not to legislate investment inflexibility. For all its imprecision and uncertainties—and we share your concerns about its impact on pension fund management and on capital markets—ERISA's prudent man rule has the virtue of flexibility. We suggest that you focus your attention on clarification of ERISA's flexibility. Rather than legislating what may become the first of a series of prudent man investment "pockets," you should indicate, clearly, that, under ERISA's prudent man rule, prudence is determined not by looking at a particular investment by itself, but rather by looking primarily at the reasonableness of the total portfolio of which that investment is a part, viewed (at the time at which the investment was made, held or sold) in the light of the overall circumstances, including the objectives and requirements of the plan. If you will remove uncertainty about this facet of the operations of ERISA's prudent man rule, investment decisions (whether with respect to investment in securities of companies with capital of more than $150,000,000, in companies with paid-in capital of less than $25,000,000, in venture capital funds, or in the myriad of other investment opportunities presented a pension fund account) will flow from, and will be measured by, the appropriate dynamic standard. Such a clarification would be of great service.

Respectfully submitted.

PAUL J. MILLER,
Chairman, Legislative Committee.

STATEMENT OF HARRY V. LAMON, JR., AT A HEARING ON H.R. 4340 BEFORE THE SUBCOMMITTEE ON LABOR STANDARDS OF THE COMMITTEE ON EDUCATION AND LABOR, U.S. HOUSE OF REPRESENTATIVES

Good morning, Mr. Chairman and members of the Committee. I am Harry V. Lamon, Jr., of the law firm of Henkel & Lamon, P.C., Atlanta, Georgia. As some of you may know, I am a member of the Advisory Council to the Secretary of Labor on Employee Welfare and Pension Benefit plans, serving as a representative of the general public, as Chairman of the Small Plans Impact Work Group, and as a member of the Minimum Standards Work Group and the Legislative Work Group. I am also a member of the Panel on Contingent Employer Liability Insurance established by the Pension Benefit Guaranty Corporations.

Although the Advisory Council, in January of 1977, by a vote of 14 to 1, endorsed the concept of consolidation of all ERISA administrative and enforcement functions in a single agency,[1] I am not appearing here today as a member of the Advisory Council. Rather, I am here in my capacity as General Counsel of the National Association of Pension Consultants and Administrators, Inc., (NAPCA), and as a concerned individual who has been involved in the pension industry for over twenty years and who is vitally interested in the continued viability and growth of a sound private pension system.

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[1] Attached as Exhibit No. 1 is a copy of the resolution adopted by The Advisory Council on Employee Welfare and Pension Benefit Plans on January 11, 1977.

When pension reform was being considered initially, I, along with many other tax practitioners, supported retention in the Internal Revenue Service of the administrative and enforcement functions relating to qualified retirement plans. The reason for such support, primarily, was because the Internal Revenue Service was a known quantity, with existing administrative and enforcement capabilities, which I felt could fully implement the objectives of ERISA. I have never supported the concept of "dual jurisdiction". Dual jurisdiction resulted, as you know, from a legislative compromise, and I believe it to be truly analogous to a ship at sea with two captains, neither of whom is quite sure who is in command. In many respects, ERISA today reminds me of a Liberian oil tanker. Seriously, Mr. Chairman, in any organization, the buck must stop somewhere. Under ERISA, it is being passed back and forth between the Internal Revenue Service and the Department of Labor. The history of dual jurisdiction over the past two and half years has convinced me that it is just not a practical approach to the problem.

Throughout this period of time, I have been intimately involved in dealing with the problems which have arisen under ERISA. As part of my employee benefit plan activities, I have analyzed literally hundreds of legislative proposals to amend ERISA to resolve some of the substantive difficulties, and have been involved in consideration of countless other problems. The common denominator of a substantial majority of these problems is dual jurisdiction. The problems have been particularly acute in the areas of (1) reporting and disclosure, including forms and deadlines; (2) prohibited transactions and fiduciary responsibility, where the uncertainty created by the party in interest rules, and the inability of the agencies to get together on many needed exemptions, has severly penalized many innocent plan fiduciaries; and (3) enforcement activities as best exemplified by the uncoordinated agency action with respect to the Central States Teamsters' Pension Fund.

I fully recognize that progress has been made in the implementation of ERISA, and quite candidly I highly compliment the agencies for the progress to date. However, as this Subcommittee well knows, even this much progress has come only after a truly inordinate amount of time, expense and hard work on the part, of the Congress, the agencies, and the public. It is my considered judgment that the jurisdictional problems are institutional, and I have no reason to believe that the situation will significantly improve absent a legislative change.

Mr. Chairman, there appear to be two basic philosophies as to how the dual jurisdiction problem might be addressed. One is the concept of "consolidation of functions" as exemplified by H.R. 4340. The second is the concept of "statutory allocation of functions" as exemplified by S. 901, recently introduced in the Senate by Senator Lloyd Bentsen of Texas. I am very supportive of H.R. 4340, but I am also supportive of certain provisions of S. 901 as explained in Senator Bentsen's introductory statement of March 3, 1977.

I am particularly interested in the provisions of S. 901 relating to simplification and reduction of ERISA's reporting requirements and the concept of an expanded and expedited declaratory judgment procedure. I further support the concept of retention of a shared oversight responsibility among the various concerned Congressional committees, and would hope that the current debate over jurisdiction will ultimately lead to real implementation of the Joint Pension Task Force with full participation of all of the concerned committees. However, I see very real problems with the concept of statutory allocation of functions. As I understand S. 901, the Internal Revenue Service would be given jurisdiction over vesting, funding and participation, while the Department of Labor would be given jurisdiction over fiduciary responsibility and prohibited transactions. The Internal Revenue Service thus would be retaining jurisdiction over plan qualification procedures. However, as this Committee well knows, the basic requirement of a qualified plan under Internal Revenue Code Section 401(a), is that the plan be created, organized and operated for the "exclusive benefit" of employees and their beneficiaries. The "exclusive benefit rule" of the Internal Revenue Code is inextricably related to the fiduciary standards set forth in Title I of ERISA. If the Congress attempts to divide "exclusive benefit" jurisdiction from "fiduciary responsibility/prohibited transaction" jurisdiction, I am afraid we will find ourselves right back in the same "dual jurisdiction" quagmire in which the pension industry is now bogged down. Accordingly, I appear here today in strong support of the concept of consolidation as the only realistic alternative for resolving the jurisdictional problems which to date have so hampered the administration and enforcement of ERISA.

I last appeared before this Subcommittee in July of 1976, testifying primarily on problems in the area of prohibited transactions. At that hearing, in a dialogue with Chairman Dent, I expressed some reservation about the feasibility of creating a new independent federal agency to administer and enforce ERISA. On reflection, I continue to be concerned over the logistical problems and the potential disruption to the momentum that does exist if an attempt is made to transfer all ERISA administrative and enforcement functions to a new independent agency.

The dual jurisdiction problems are acute, and it has been my thought that the most immediate action possible should be taken. For this reason, I have strongly supported the position of the Advisory Council, which is to transfer to an existing agency, the Department of Labor, all administrative and enforcement functions, but with priority given to transfer of those problem areas which are most pressing. Thus the most acute problems could be addressed immediately, and the other functions could be transferred on a scheduled, step-by-step basis. If it is the judgment of this Subcommittee that immediate action is required in specific areas, I still favor this approach. On the other hand, my overriding concern is to obtain consolidation of the administrative and enforcement functions of ERISA under a single body, whether a new agency or a new consolidated administration within an existing department or agency. I am confident that this Subcommittee will give due consideration to the comparative logistical and practical problems involved in the two approaches.

Given these overall comments on the problems of dual jurisdiction and the need for consolidation, I would now like to offer a few comments on specific provisions of H.R. 4340.

(1) Section 3001 of H.R. 4340 provides for the Board of Directors and officers of the proposed Employee Benefit Administration. Subsection (b)(1) provides that the Board shall consist of three individuals: the Secretary of Labor or his delegate, the Secretary of Treasury or his delegate, and a third person appointed by the President. Subsection (b)(2) provides that the Board shall appoint an Executive Director to serve as the chief operating officer of the Administration. I suggest that Section 3001 be modified to provide that the Executive Director shall be the third voting member of the Board of Directors. This is more than just a technical change. I think it very important that the chief operating officer of the Administration have a direct and substantial involvement in the establishment of the policies which will guide the Administration and not just the duty to implement policies established by the Board.

(2) Sections 3003(c) and 3007 provide the general authorization for the transfer and consolidation of components, personnel and resources of existing agencies into the proposed Employee Benefit Administration. The language of these sections leaves substantial discretion in the President of the United States. Such discretionary language in the legislation itself is entirely appropriate in view of the practical and political considerations which are obviously involved. However, I would urge the Congress, at a minimum, to go on the record in the appropriate Committee Reports by noting that a competent and qualified field force under the jurisdiction and supervision of the Executive Director is essential to the success of any attempt at consolidation. The qualification function and the audit function simply will not work effectively from a single national office. There must be a field force which can effectively perform those critical functions at the regional or local level. I am certain that this is the intent of the proposed legislation. I would urge that the Congress specifically so state in the appropriate Committee Reports so that the means for developing such a field force, or for transferring such existing Internal Revenue Service and Department of Labor personnel to such field force, can be accomplished as an integral part of the establishment of the Employee Benefit Administration.

(3) Section 3005 of H.R. 4340 would establish certain procedures dealing (a) with the notification of employees of the request for a favorable determination letter from the Employee Benefit Administration and (b) with the requirements for intervention by the Pension Benefit Guaranty Corporation or the Secretary of Labor in a declaratory judgment action brought under Internal Revenue Code Section 7476. Although I understand that H.R. 4340 is not designed to deal with substantive ERISA matters, and particularly is not designed to be a "Christmas Tree" vehicle for miscellaneous substantive ERISA amendments, I am concerned that this provision does not address a very real procedural problem under the declaratory judgment provisions. The problem is not that of dual or multijurisdiction, but is the failure of a government entity to assert appropriate jurisdiction. In my view, the Tax Court has taken an overly restrictive view of

its jurisdiction under Section 7476, with the result that the purpose of Section 7476—to enable employers, plans, participants, beneficiaries, and other interested parties to obtain a prompt review of a plan's qualification either where the Internal Revenue Service has ruled adversely or has failed to rule within a reasonable period of time—is not being fulfilled.

In *Federal Land Bank Association of Asheville* v. *Commissioner*, 67 T.C. No. 4, decided in October, 1976, the Tax Court held that it had no jurisdiction to render declaratory judgments with respect to plans involving pre-ERISA years, primarily due to its analysis of the interaction of ERISA Section 3001 and Internal Revenue Code Section 7476. In two Memorandum decisions, the Court subsequently confirmed its position that it has no jurisdiction over plans in existence in January 1, 1974, when the plan year begins before January 1, 1976. *Miller & Kearney, P.C.*, T.C. Memo 1977-16 (January 26, 1977); *Metadure Corporation* v. *Commissioner*, T.C. Memo 1977-37 (February 16, 1977).

In *Shepherd & Myers, Inc.* v. *Commissioner*, 67 T.C. No. 3, also decided in October, 1976, the Court held that it had no jurisdiction to render declaratory judgments with respect to questions involving the continued qualification of a plan unless the questions were occasioned by a plan amendment or a plan termination. Thus questions of "qualification in operation" were thereby precluded from review under the declaratory judgment procedure.

In *Prince Corporation* v. *Commissioner*, 67 T.C. No. 25, decided in November 1976, the Tax Court held that it had no jurisdiction to render a declaratory judgment with respect to a plan's qualification even though the 270 day period had expired since the application for a determination letter was filed. The Court held that despite expiration of the period, the taxpayer still had to establish that he had exhausted his administrative remedies. The unfortunate implication of this case is that the Internal Revenue Service can hold up action on a plan indefinitely and the taxpayers who sponsor the pension benefit plans can obtain no relief.

To my knowledge, in only one case, *Hill, Farrer & Burrill* v. *Commissioner*, 67 T.C. No. 33 (December 14, 1976), has the Tax Court reached the merits in an action brought under Section 7476.

Without unduly criticizing the Tax Court, I conclude from these cases that the Court is not particularly anxious to assert jurisdiction under Section 7476. The proposed procedures of Section 3005 of H.R. 4340, in not addressing the jurisdictional restrictions found by the Tax Court in existing law, imply agreement with such restrictions. I hope you will agree with me that more than just tax considerations are involved, and that a plan of concurrent jurisdiction similar to that provided for other tax exempt organizations under IRC Section 7428 should be provided. To properly fulfill what I understand was the intent of Section 7476, I would suggest the following:

(*a*) Modify Section 3005 of H.R. 4340 to insure that its notice procedures will not be construed to prohibit a declaratory judgment proceeding with respect to a pre-ERISA plan or a plan not required to comply with ERISA such as a pension benefit plan for church employees.

(*b*) Modify Section 7476 of the Internal Revenue Code to insure that expiration of the 270 day period without agency action and without mutual extension will be conclusive of the fact that the petitioner has exhausted his "administrative remedies."

(*c*) Modify Section 7476 of the Internal Revenue Code to provide for concurrent jurisdiction of the Court of Claims, the Federal District Courts, and the Tax Court. (Compare with Internal Revenue Code Section 7428 regarding declaratory judgments relating to the status of Section 501(c)(3) organizations).

To briefly summarize, I strongly support the basic concept of H.R. 4340 and am gratified that this Subcommittee is now directly attempting to solve the dual jurisdiction problem. I sincerely hope that this Subcommittee will be able to work effectively with the other involved Committees, both in the House and in the Senate, to develop a workable solution to the dual jurisdiction problem. If you do, the people of this Nation will be well served. Thank you for allowing me to appear today.

EXHIBIT NO. 1

By a vote of 14 to 1 the Advisory Council, On January 11, 1977, adopted the following recommendation:

"The dual jurisdiction problem should be solved by a legislative amendment transferring to the Department of Labor all authority for interpreting, administering and enforcing ERISA, including fiduciary responsibility and prohibited transactions, with the exception of matters which are strictly questions of Federal taxation, e.g., deductibility of contributions, taxation of nonqualified trusts, taxation of distributions.

"The excise tax provisions would be eliminated and prohibited transactions would be enforced by civil remedies. The Department of Labor would have sole responsibility for certifying employee plans and trusts, and the IRS would be bound to accept such certification as conclusive of the issue of qualification.

"This objective may have to be achieved in several steps and priority should be given to the transfer of fiduciary and prohibited transaction sections to DOL's sole jurisdiction.

The Advisory Council also expressed opposition to the creation of a third regulatory agency.

AMERICAN COUNCIL OF LIFE INSURANCE,
Washington, D.C., June 16, 1977.

Hon. LLOYD BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BENTSEN: The American Council of Life Insurance ("Council") appreciates this opportunity to comment on S. 285. This bill, as here pertinent, would impose a penalty tax on a manager of more than $1 billion of pension assets who acquired, with those assets, more than 5 percent of any class of security of any corporation over a stated size. In addition, the bill would exempt from federal and state definitions of the "prudent man rule" the investment by a fiduciary of up to 2 percent of the assets of a trust, which is part of a qualified pension plan, or of an investment company, in the securities of any corporation under a stated size. The Council, on behalf of its 467 life insurance company members, does not favor the enactment of these measures.

S. 285 has its origins in the so-called "two-tier" stock market associated with the early 1970's. At that time, and notwithstanding evidence to the contrary, it was asserted that institutional investors, in general, limited their investments to a select group of large companies, the "top-tier", and left floundering, with inadequate sources of capital, smaller issuers who constituted a "second-tier". In 1973, in testifying before your subcommittee on this alleged phenomenon and in a subsequent statement on S. 2842 (93d Cong., 1st Sess.), the present bill's precursor, the Council's predecessor organization, the American Life Insurance Association, stated that while there was no evidence to support the hypothesis of a "two-tier" market, to the extent such a market might exist, it would be a by-product of general economic conditions rather than a direct product of investor design. History has demonstrated accuracy of this statement, and no one now seriously asserts the existence of a two-tier market or an absence of diversification in pension investments.

Numerical limitations, to a significant degree, are arbitrary, and should not be used, particularly in a statute, unless necessary to correct an established, specific wrong. Because there has been no abuse of discretion by pension managers, there is no warrant to impose on them a federal standard which, in the absence of a specific need, will serve only as a precedent for establishing further artificial barriers in the marketplace.

The second part of S. 285, the 2 percent exception to the "prudent man rule", is intended to divert pension assets to small companies. If in fact it is in the national public interest to encourage the investment of retirement funds in such issuers, tax incentives should be provided to allay the high cost and unusual risk these investments entail. Upsetting established concepts in state and federal law by creating two prudent man rules, one for large issuers and another for small issuers, is too dear a price to pay for a tenuous solution to an undefined problem.

Thank you for your attention to our views, copies of which we have sent the other members of your subcommittee.

Sincerely yours,

LARRY M. ROSENSTEIN,
Assistant General Counsel.

STATEMENT OF MORRIS GOULD

SIMPLIFICATION OF ERISA

(1) I am president of Pension Counsellors, Inc. of Rockville Centre, New York and have devoted at least 95 percent of my time exclusively, for almost 25 years, to the design, installation and servicing of pension and profit sharing plans, exclusively for small business. It is our proud boast that in all this time we have been able, in conjunction with the attorneys and accountants of our clients, to guide them in this activity with the result that never has a single client been confronted with the penalties of the law for failing to comply, nor has a single common law employee received less than 100 percent of the amount to which he was entitled upon termination of employment or dissolution of such plans.

(2) As to simplification of ERISA: We are opposed to it. We believe that for large plans, for instance those of the giant corporations, those negotiated by the giant unions, the multi-employer plans, the structures of ERISA are essential. These organizations have available the legal, actuarial and accounting specialists to enable them to meet the requirements at a nominal cost per employee. It has been shown time and again that in each of this type of plan, there have been wide-spread abuses which it is hoped will be eliminated by the strict application of the terms of Erisa.

(3) The same is not true of plans with less than 100 participants. Requiring such small plans to meet all of the strictures of Erisa constitutes "crush'ng the little guy" as very aptly stated before your subcommittee by Senator McIntyre. Small business must have access to fringe benefit programs in order that they may contend for qualified personnel with their giant competitors. To make compliance so difficult and costly for these small plans is tantamount to promoting the eventual disappearance of small business from the economic scene. Between 1972 and 1974 we saw the excesses of big business; it is respectfully submitted that one of the very healthy ways of making sure that big business does not continue such excesses is by making sure there is a very vital and viable small business segment which can compete effectively, and "blow the whistle" when necessary. The effective way to accomplish this happy result is by changing Erisa so that some of these strictures are not applicable to plans with less than 100 lives.

(4) There are many fringe benefit arrangements available to giant business which small business is unable to institute. Because to the giant corporation it makes little difference whether an expense is currently deductible or is deductible later on when paid out, they can promise their executives retirement benefits far in excess of the limitations imposed by Erisa. Attached hereto and made a part hereof marked Exhibit A, is a letter from Honeywell Inc., dated May 16, 1977 indicating that whereas prior to Erisa they had provided for certain retirement benefits on a currently deductible basis, those in excess of the limits imposed by Erisa are being continued even though the deduction will come when the benefit is paid out. The typical small business does not have the kind of cash flow that would enable it to provide for this kind of additional benefit. In 95 percent of the cases that kind of undertaking would not be possible nor relied upon by the employee, for obvious reasons. This is another reason why, and there are many others, access to fringe benefit plans should be made easier for the small business as otherwise they will completely lose out in attempting to acquire competent personnel.

(5) A typical pension plan for small business is integrated with Social Security. Broadly speaking this means that roughly one half of the Social Security benefit expected at age 65 is deducted from the total benefit promised, and the balance is provided by employer contributions to a private plan. Because Social Security benefits are heavily weighted in favor of lower paid employees, this in turn means that in the typical private plan up to 90 percent of the funds involved are used to pay for the benefits of working stockholders and other highly paid people. (The Committee should bear in mind that of the total Social Security cost, more than one half is paid by the employer.) Under these circumstances, why would anyone controlling the plan such as a stockholder-employee-trustee wish to act improperly in connection with those funds since most of it will be devoted to the benefit of himself and other people about whom he is vitally concerned?

(6) We submit that in small plans it would be entirely satisfactory to eliminate the frequent actuarial certifications required for large plans and instead

merely to require that before any of the ten highest paid people in such small plans may derive any benefit therefrom, that there be certification by a registered actuary that after disbursement of such benefit the plan will have sufficient assets to meet its obligations to the remaining participants.

(7) The attached chart marked "Exhibit B", was published by the Equitable Life Assurance Society of New York. All companies heavily engaged in providing individual policy pension trust products have published similar charts, prepared by graduate actuaries experienced in qualified pension plans. These are the charts that we have been using for almost 25 years to extrapolate the figures required in designing a given plan. We request that this Committee call before it a graduate actuary experienced in the pension field and with stature in that field and ask him to testify under oath as to whether any figures that he might prepare for a fee of less than $1,000, let's say, for a plan with ten participants, would be more accurate than any of the figures set forth in Exhibit B.

(8) In the period after 1972 we have seen that lawyers (including Attorneys General of this Country), certified public accountants and others of recognized stature have committed perjury. It would be too much to expect that actuaries would not "adjust" their figures. Would it not be better in small plans to have a series of charts like Exhibit A certified by the insurance company actuaries, rechecked by government actuaries and then made available for use by lay actuaries who have been doing this kind of work for a great number of years, in connection with the calculations required by qualified plans with less than 100 participants. This would result in eliminating extra costs for small plans which are too high on a per capita basis.

(9) One of the very obvious advantages is that these charts, on file with IRS, would be available for instant rechecking by IRS auditors in order to determine whether the contributions to a plan within the minimum or maximum funding standards.

(10) This is one approach. There could be others but by utilizing charts of this kind we could avoid the requirement that a small plan be saddled with the expense of up to $100 per participant for actuarial services each year whereas the cost to the large plan would be limited to pennies per year per participant.

(11) As a matter of fact, Congress in its wisdom, provided in Section 3042(a) of ERISA (as amplified in the House-Senate Conference Committee Report 93-1280 page 361), that the actuarial services for small plans continue to be provided by people with proven experience in the field using widely published actuarial tables, at little or no cost to the client. This has been common in our industry for 50 years. Congress provided that this continue. The Joint Board for the Enrollment of Actuaries (controlled by actuaries) has countervened this Congressional mandate. Why is it not just as satisfactory to provide that before the stockholder can take his benefit out of a plan, he must only furnish a report from an enrolled actuary that the assets remaining are sufficient to provide the benefits promised the common law employees?

(12) Most important decisions regarding actuarial matters are left to the Joint Board for the Enrollment of Actuaries, which is itself controlled by actuaries. Congress must look into the possibility of a conflict of interest created when actuaries are permitted to establish regulations requiring unneeded use of those services. This inflates the cost and at the same time increases the profits of actuarial firms, at the expense of small business. It is a typical example of Congress having hired a fox to patrol the henhouse and must be changed.

(13) PS 58 rates now being used were promulgated in March of 1947, based on insurance rates at that time. Everyone in the industry, as well as the Washington bureaucrats involved in these matters, are fully aware of the fact that insurance rates have come down 20 to 40 percent during those 30 years. Since it is cheaper for small business to provide life insurance coverage under a pension plan than any other way, this important segment of our economy, and their employees, are being discriminated against unnecessarily. After thirty years, it is certainly time to revise these rates so as to provide equity for small business.

(14) In order to provide a quick solution to one of the more irritating aspects of Erisa, I recommend your calling the Chairman or other operating officer of the Joint Board for the Enrollment of Actuaries to determine by what subversion of the English language they are able to change the clear mandate of Congress as set forth in Section 3042(a) of Erisa as amplified in Committee Report 93-1280, page 361. If upon studying this segment of the law, this Sub-

committee interprets it as written, then obviously the Joint Board for the Enrollment of Actuaries is in clear conflict with the law and should be instructed to correct their position. This would eliminate unnecessary expense and paperwork, and remove other burdens from the backs of small business.

EXHIBIT A

MAY 16, 1977.

Mr. MORRIS GOULD,
Trustee, Pension Counsellors, Inc.,
Rockville Centre, N.Y.

DEAR MR. GOULD: Recently you addressed a letter to Mr. Spencer, President of Honeywell, inquiring as to how pension payments in excess of ERISA limits could be paid from our Retirement Plan.

We have amended the Retirement Plan in accordance with ERISA so that no more benefits could be paid from that trust than allowed by the law and regulations.

Since ERISA would have, in effect, reduced the retirement benefits that would have been paid from the plan without ERISA, we created a new Supplementary Retirement Plan through which the difference in benefits would be paid. This plan has been approved by the Honeywell Board of Directors. It has not been submitted to the IRS for qualification, nor is it intended that the Company will do so. The cost of the plan is not funded through a trust, but benefits will be paid if and when necessary from operating funds.

If you have any further questions on this matter, please feel free to contact me.

Very truly yours,

EVERETT G. SHERMAN,
Manager of Benefit Administration.

EXHIBIT B

PENSION PLAN LIFE POLICY

[1st year deposit to auxiliary fund on various bases corresponding to single consideration required at retirement age for increase in monthly life income, 10 yr certain to pro[illegible] $10 per $1,000 face amount including monthly income produced by policy cash value]

Female, age at issue	Ret. age	C.V. at ret. age	Mo. inc. from C.V.	S. sum to incr. mo. inc. to $10	1st year deposit: Basis G2 1958 CSO 3½ percent no term.	Basis H2 1958 CSO 3½ percent terms.	Basis I2 1958 CSO 4 percent no. term.	Basis F2 1958 CSO 4 percent terms.	Basis K2 1958 CSO 4½ percent no. terms.	Basis O2 1958 CSO 4½ percent terms.	Basis J2 4 percent int. only	Basis L2 4 percent int. only	Basis M2 5 percent int. only	Basis N2 5½ percent int. only
20	65	601	3.32	1,2[illegible]2	8.48	4.64	7.35	3.94	6.36	3.34	9.95	8.63	7.47	6.45
21	65	598	3.30	1,255	8.91	5.05	7.75	4.31	6.73	3.67	10.46	9.10	7.91	6.85
22	65	594	3.28	1,260	9.37	5.52	8.18	4.73	7.13	4.05	11.01	9.62	8.39	7.30
23	65	591	3.26	1,263	9.85	6.01	8.63	5.18	7.55	4.45	11.59	10.16	8.89	7.77
24	65	587	3.24	1,267	10.36	6.55	9.11	5.67	8.00	4.90	12.20	10.74	9.44	8.28
25	65	583	3.22	1,271	10.91	7.13	9.63	6.20	8.48	5.38	12.86	11.36	10.02	8.82
26	65	579	3.20	1,275	11.50	7.76	10.18	6.78	9.00	5.92	13.56	12.02	10.64	9.40
27	65	574	3.17	1,280	12.13	8.45	10.78	7.42	9.57	6.50	14.32	12.74	11.32	10.04
28	65	570	3.15	1,284	12.80	9.19	11.41	8.11	10.16	7.84	15.11	13.50	12.03	10.71
29	65	565	3.12	1,290	13.53	10.01	12.11	8.86	10.82	7.48	15.98	14.33	12.82	11.45
30	65	560	3.09	1,295	14.30	10.88	12.85	9.68	11.52	8.60	16.91	15.21	13.66	12.24
31	65	555	3.06	1,300	15.14	11.81	13.64	10.56	12.28	9.42	17.89	16.15	14.55	13.10
32	65	549	3.03	1,306	16.04	12.83	14.51	11.52	13.10	10.32	18.97	17.18	15.54	14.03
33	65	543	3.00	1,312	17.02	13.93	15.45	12.55	14.00	11.30	20.12	18.28	16.59	15.04
34	65	537	2.96	1,319	18.09	15.12	16.47	13.69	14.98	12.37	21.38	19.49	17.75	16.15
35	65	530	2.93	1,326	19.24	16.41	17.58	14.92	16.04	13.54	22.73	20.80	19.01	17.35
36	65	523	2.89	1,333	20.50	17.81	18.79	16.25	17.20	14.81	24.20	22.21	20.37	18.66
37	65	516	2.85	1,340	21.86	19.32	20.10	17.69	18.47	16.19	25.79	23.75	21.85	20.09
38	65	508	2.80	1,349	23.37	20.99	21.56	19.30	19.88	17.73	27.55	25.46	23.50	21.68
39	65	500	2.76	1,357	25.01	22.79	23.15	21.03	21.41	19.39	29.45	27.30	25.28	23.40
40	65	491	2.71	1,366	26.83	24.77	24.91	22.94	23.12	21.23	31.[illegible]4	29.33	27.26	25.31
41	65	482	2.66	1,376	28.84	26.95	26.87	25.05	25.01	23.28	33.85	31.58	29.45	27.44
42	65	473	2.61	1,385	31.04	29.33	29.01	27.36	27.10	25.51	36.37	34.04	31.84	29.76
43	65	463	2.56	1,395	33.50	31.96	31.41	29.92	29.43	28.00	39.17	36.77	34.50	32.36
44	65	452	2.50	1,407	36.29	34.92	34.12	32.80	32.07	30.80	42.32	39.85	37.51	35.29
45	65	441	2.43	1,418	39.37	38.17	37.14	35.98	35.98	33.90	45.79	43.25	40.84	38.55
46	65	429	2.37	1,430	42.85	41.83	40.55	39.56	38.35	37.39	49.69	47.08	44.60	42.22
47	65	416	2.30	1,444	46.24	45.99	44.46	43.63	42.18	41.38	54.14	51.45	48.88	46.43
48	65	403	2.22	1,457	51.33	50.65	48.87	48.20	46.51	45.86	59.12	56.35	53.70	51.16
49	65	389	2.15	1,472	56.33	56.00	53.98	53.46	51.53	51.03	64.85	62.00	59,26	56.62

50[1]	65	374	2.06	1,487	62.51	62.13	59.87	59.49	57.33	56.96	71.41	68.46	65.63	62.35
51	65	359	1.98	1,503	69.49	69.23	66.75	66.49	64.11	63.86	79.01	75.97	73.04	70.99
52	65	342	1.89	1,520	77.71	77.55	74.86	74.71	72.11	71.96	87.90	84.76	81.73	78.78
53	65	324	1.79	1,539	87.54	87.47	84.58	84.51	81.71	81.64	98.48	95.24	92.08	89.37
54	65	306	1.69	1,558	99.33	99.30	96.24	96.22	93.25	93.22	111.08	107.72	104.44	101.04
55	65	286	1.58	1,578	113.73	113.73	110.51	110.51	107.38	107.38	126.38	122.89	119.48	116.27
56	65	265	1.46	1,600	131.72	131.72	128.35	128.35	125.06	125.06	145.37	141.74	138.19	134.10
57	65	242	1.34	1,624	154.68	154.68	151.14	151.14	147.68	147.68	169.47	165.68	161.97	158.78
58	65	215	1.19	1,652	185.00	185.00	181.26	181.26	177.61	177.61	201.11	197.14	193.24	189.37
59	65	186	1.03	1,682	226.17	226.17	222.21	222.21	218.31	218.31	243.83	239.63	235.51	231.43
60	65	156	.86	1,713	284.61	284.61	280.36	280.36	276.18	276.18	304.10	299.64	295.25	290.42
56	66	321	1.66	1,525	108.51	108.51	105.43	105.43	102.44	102.44	122.13	118.76	115.47	112.97
57	66	300	1.53	1,547	125.85	125.85	122.63	122.63	119.48	119.48	140.56	137.05	133.62	130.19
58	66	248	1.40	1,571	148.01	148.01	144.62	144.62	141.30	141.30	163.94	160.27	156.68	153.06
59	66	220	1.25	1,600	177.42	177.42	173.83	173.83	170.31	170.31	194.79	190.93	187.16	183.41
60	66	191	1.08	1,630	217.26	217.26	213.44	213.44	209.69	209.69	236.30	232.23	228.23	224.33
61	66	160	.91	1,662	274.01	274.01	269.92	269.92	265.89	265.89	295.05	290.71	286.45	282.20
57	67	300	1.74	1,471	103.21	103.21	100.27	100.27	97.42	97.42	117.81	114.55	111.38	108.28
58	67	278	1.62	1,494	119.97	119.97	116.88	116.88	113.88	113.88	135.74	132.35	129.04	125.86
59	67	255	1.48	1,517	141.22	141.22	137.97	137.97	134.81	134.81	158.30	154.76	151.29	147.94
60	67	226	1.31	1,547	169.68	169.68	166.24	166.24	162.87	162.87	188.34	184.61	180.96	177.37
61	67	196	1.14	1,578	208.29	208.29	204.62	204.62	201.03	201.03	228.76	224.82	220.95	217.13
62	67	165	.96	1,610	263.19	263.19	259.25	259.25	255.38	255.38	285.82	281.62	277.49	273.44
58	68	307	1.83	1,419	98.03	98.03	95.24	95.24	92.52	92.52	113.64	110.50	107.44	104.44
59	68	285	1.70	1,442	114.14	114.14	111.20	111.20	108.33	108.33	131.02	127.75	124.55	121.42
60	68	261	1.56	1,467	134.77	134.77	131.67	131.67	128.64	128.64	153.08	149.66	146.30	143.07
61	68	232	1.38	1,497	162.24	162.24	158.94	158.94	155.72	155.72	182.25	178.64	175.11	171.60
62	68	201	1.20	1,529	199.67	199.67	196.15	196.15	192.69	192.69	221.66	217.84	214.09	210.41
63	68	169	1.01	1,563	252.96	252.96	249.16	249.16	245.43	245.43	277.29	273.22	269.22	265.29
59	69	314	1.92	1,362	92.57	92.57	89.92	89.92	87.34	87.34	109.16	106.14	103.20	100.32
60	69	291	1.78	1,387	108.05	108.05	105.26	105.26	102.54	102.54	126.02	122.87	119.80	116.82
61	69	267	1.64	1,412	127.84	127.84	124.88	124.88	122.00	122.00	147.34	144.05	140.82	137.64
62	69	237	1.45	1,443	154.33	154.33	151.18	151.18	148.10	148.10	175.68	172.20	168.79	165.44
63	69	206	1.26	1,475	190.34	190.34	186.98	186.98	183.68	183.68	213.83	210.14	206.52	202.96
64	69	173	1.06	1,509	241.84	241.84	238.21	283.21	234.64	234.64	267.88	263.95	260.08	256.21

[1] These tables applicable also defined benefit pension plan annuity with option to increase monthly annuity, where issue age and retirement age are the same as the issue age and retirement age shown above, for the corresponding increase in monthly life income, 10 yr certain.

Note: Termination rate reflected is 5 percent per year at ages to 30, decreasing thereafter by 1/7-percent for each year of age over 30 to 0 percent at age 65.

MICHIGAN GENERAL CORPORATION,
Dallas, Tex.

SENATE FINANCE COMMITTEE,
Washington, D.C.

DEAR SIRS: The purpose of this letter is to comment to the Senate Finance Committee on my views regarding the "Prudent Man Rule," the regulation of ERISA, and the difficulty of small- and medium-sized companies to secure capital funds through the sale of stock and/or the sale of debt with or without warrants and convertibility rights.

The vast boom in the American economy for the past 30 years has been fueled by the availability of capital funds on a wide scale. Now such funds have been severely limited to companies in the two following categories: (1) under $25 million in net worth; and (2) those enterprises with less than $100 million in market value securities. This state of affairs is incredibly anti-competitive and has a long-range debilitating impact on our economic system.

Since the 1920's, insurance companies have been loaning money on a major scale to private industry in the United States. Many of these loans even today go down to as low as $1 million. It is perfectly sound to lend $1 million to a $5 million capitalized corporation—or it was before ERISA. If an insurance company's loan officer made a series of bad loans, all he could do was lose his job, and some did. But most did not. American industry has had its ups and downs but on balance no one can debate it has not been extraordinarily productive. Under ERISA, however, both the loan officer and the trustees face severe punitive risks. Hence, they will no longer loan $1 million to a company capitalized at $5 million even though it truly is a "prudent" loan.

On December 31, 1969, my company, Michigan General Corporation, had a net worth of $23,848,677, including $16,952,626 in intangibles, so our tangible net worth was only $6,896,051. Despite that, five insurance companies led by Aetna in June of 1970 loaned Michigan General $8.5 million in 15-year senior notes with warrants attached. Because of the influence of ERISA, no such loan by any insurance company or pension fund would be made today. Why? Because ERISA sets the pattern. Only a few, the brave and the large insurance companies, will have the nerve to adopt a more lenient loan policy than that permitted by the government for its pension funds. The destructive fallout of ERISA goes far beyond the limitations on pension fund money, which in and by itself is undeservedly severe and damaging, especially to all young and growth-oriented companies, however deserving.

Attached hereto is the breakdown between the common stock issues sold for the first time to the public and common stock issues of those companies already public. But the critical column is the one on the left. This decline is so precipitous and total that, if properly presented, no politician or economist could possibly refute the long-run negative effects on our independent economic system. Logic and conversation are important, of course, but those statistics reflect a virtual wipe-out of common stock for new companies during a period of unparalleled prosperity which the United States has enjoyed since 1969 in spite of two recessions, OPEC, two stock market debacles, inflation, two banking crises and price controls.

Congress has unintentionally passed legislation which will have the likely impact of reducing the financial strength of all medium-sized and small business, including those firms like the two which I have co-founded within the past 11 years: Tyler Corporation and Michigan General Corporation. Both of these companies started with zero and have grown to the top 1,000, according to Fortune's industrial list. We are the competition for the giant corporations of America. If we had not been able to raise funds from the pension funds of Morgan Guaranty, Prudential, Aetna, etc., our growth would never have taken place. This includes the tremendous growth in employment in those companies which we have funded—all of this within the recent 11-year period.

Tyler Corporation was founded on January 31, 1966. The first three acquisitions had a total of $4 million in sales. Last year sales of the corporation were $300 million. Michigan General Corporation was founded on March 28, 1968, and the sales for its first acquisition were $4,200,000. This company's sales have grown to $169 million last year.

Neither company could be founded under today's rules. This limitation would represent a tremendous loss, not only to the United States' economic system, but to all of its citizens.

Congress, in passing laws aimed at giant corporations, is trying to cure weaknesses in our economic system which affect less than 2 percent or 3 percent of the total number of enterprises. The fall-out effect is tragic and somehow something should be done to blunt the disastrous results caused by the 1969 and 1976 Tax Reform Acts as well as by the new law on pension funds.

I would gladly come to Washington to testify on this subject further either in an individual conference or public hearing if, in your opinion, that would be helpful.

Sincerely yours,

IRA G. CORN, Jr.

Enclosure.

MEMORANDUM—JUNE 7, 1977

Subject: New Issues of Common Stock

Source: Research Department Investment Dealers Digest—Anthony Ricotta

(1) The issues set forth in paragraph two of this memorandum includes filings under Regulation A of $500,000 in value and less, issues of common stock of companies which go public for the first time, as well as new issues of companies already public held. Common stock issues of companies going public for the first time are shown in Column A. New isues by companies already publicly held are shown in Column B. The total of both columns is shown in Column C.

(2) See the following table:

	A	B	C
1969	1,298	494	1,792
1970	566	212	778
1971	446	682	1,128
1972	646	739	1,385
1973	177	234	411
1974	55	99	154
1975	24	208	232
1976	46	233	279

(3) The conclusion here is, of course, that equity financing has declined to disastrous levels and American business will suffer severe consequences as a result in the decades ahead. There are far fewer new companies entering business because of lack of funding. American business, to fund its growth over the past nine years, has had to resort to an incredible amount of debt financing. Obviously, this cannot go on forever. The principal cause of this trend is the sharp altering of the capital gains tax of 1969 and the unwillingness of Congress to give individuals full tax credit for capital losses. If Congress is going to continue the severe deterioration of the capital gains tax incentive, then it must consider offering some kind of alternative. And the one that would be most fair would be to give individuals immediate relief when they suffer a capital loss, much the same as corporations are given relief when they put money in a new operation and it subsequently is liquidated at a loss because neither one of these means of softening of the blow are available to the individual investor. The result is that investors are looking only for safety. Enterprises are not being organized with anything like the frequency or effectiveness of the period from 1969 and before.

IRA G. CORN, Jr.

APPENDIX B

Proposed IRA Amendments

Individual Retirement Account/Annuity Proposed Amendments

(BY NORMAN H. TARVER, CONSULTANT, PENSION LEGISLATION)

Enclosed are discussions of several suggestions for amending the Internal Revenue Code to make improvements in the Sections related to IRA ACCOUNTS and IRA ANNUITIES.

The main part of the enclosed materials is related to suggestions for extending IRA's to active participants in qualified plans. This part consists of three subparts:

(1) Suggestions by me for a two-tier system of contribution limits;

(2) Suggestions by John Rybka, a friend of mine, for a refinement of the two-tier system in respect to higher compensated employees;

(3) Suggestions by John Rybka for an additional refinement of the two-tier system in respect to non-vested active participants.

The remaining part of the enclosed materials consists of a series of 25 other suggestions for improving the IRA section of the Code.

Some of these suggestions are related to Spousal IRA Combinations (Regular IRA's plus Spousal IRA's) as introduced into the Code by the Tax Reform Act of 1976.

Some suggestions are related to the Proposed IRA Regulations that were released as final regulations. If these suggestions cannot be made by amending the Regulations, it is suggested that appropriate changes be made in the provisions in the Code.

CONTRIBUTIONS BY ACTIVE PARTICIPANTS

Basic considerations

It is suggested that every individual taxpayer and spouse should be encouraged to accrue during their income-earning years, savings of sufficient magnitude that they will be able, throughout their retirement years, to maintain a standard of living reasonably comparable to the standard that they maintained in their income-earning years.

Included in such savings would be any contributions made by the taxpayer's employer on behalf of the taxpayer for retirement purposes. And included in the retirement pension would be Social Security. Personal savings, employer contributions and Social Security together should provide the desired standard of living.

Based on these fundamental principles, it is submitted that all the contributions needed to accrue the retirement savings (other than Social Security) should be deductible from gross income of the taxpayer or the taxable income of the employer. It is further submitted that it makes no real difference whether such contributions are made by the taxpayer or by his or her employer or partly by each, and that it makes no real difference which party secures the tax deduction in respect to such contributions.

However, because the encouragement that is provided for a particular taxpayer through the tax deduction procedure is, in effect, a subsidy provided by the general body of taxpayers, it is only reasonable that the encouragement should not be granted beyond some reasonable limit.

Moreover, the encouragement should be in a form that is easy for all to understand and practical in operation.

Capital formation

The comment is sometimes made that to permit active participants to be given permission to deduct contributions to pension plans from gross income would result in too much "tax loss". I suggest that such deductions are not really a "loss" because the money that would have been used to pay income tax is actually put aside to accumulate as capital. It is true that this accumulation is in the private sector rather than in the public sector.

In order to achieve the so-called "tax loss", a taxpayer actually has to put aside as savings considerably more than the amount of the "loss". If we assume that his or her tax rate is 20 percent, then the taxpayer must put aside five times as much as the "loss". In other words, five times as much as the "tax loss" would actually be accumulating as capital in the private sector.

Savings put aside in IRA's or in contributions to qualified pension and profit-sharing plans are long-term savings. The conditions and requirements that pertain to such contributions mean that they are not used for short-term projects.

In view of the interest in Congress at this time in the question of accumulating capital for use in the private sector, it is submitted that encouraging long-term savings is an excellent procedure for doing so.

Encouraging savings for retirement purposes means that capital is accumulated in the hands of banks, insurance companies, savings and loan associations, mutual fund companies, credit unions, etc., which quickly finds its way into housing, industry and other interests needing capital.

Uncovered employees

An important objective of Congress when it developed ERISA was to increase the number of workers participating in qualified plans. It is estimated that over 40,000,000 workers do not have pension coverage. A large proportion of these uncovered employees are employed by small corporate employers. However, many of these small corporate employers hesitate to establish pension plans for their employees because of the size of the contributions needed and because of the costs of administering pension plans. If employees could be encouraged to make contributions to the plans, then it is believed that many more of the small corporate employers would establish pension and profit-sharing plans.

Permitting tax deduction for employee contributions to qualified plans would provide such encouragement.

Practical considerations

With these thoughts in mind, I would like to submit the following suggestions for granting tax deductions for contributions made by active participants in qualified pension and profit-sharing plans.

(1) Instead of treating employee contributions to qualified plans as a form of IRA's, it is suggested that the procedure be to treat such contributions as integral parts of the qualified plans. In other words, instead of revising Code Sections 219, 220, 408 and 409 to permit employees who are active participants in qualified plans to make contributions to IRA's (or LERA's), it is suggested that Code Sections 401, 402, 403, 404, 405, 410, 411 and 415 be amended to accommodate such contributions.

(2) It is, of course, necessary to take into account the possibility that an employee may be making contributions to both an IRA and a qualified plan. The suggestion is that one limit should embrace both types of contributions. For example, if the limit were 15 percent/$1,500 for an active participant, then such limit would apply to the combined contributions to his IRA and the qualified plan. This limit could be controlled by the IRS through the forms (e.g. Forms 5498 and 5329) that he must append to his Tax Return.

(3) Also, it is necessary to take into account the contributions made to a qualified plan by the taxpayer's employer. It is suggested that this should be kept very simple so that no one needs to make any mathematical calculation. For this purpose, it is suggested that the employee's contribution limits be as follows:

(a) In the case of an active participant, the limit would be 15 percent/$1,500 for the participant's combined contributions to an IRA and to the qualified plan.

(b) In the case of a taxpayer who is not an active participant, the limit would be 15 percent/$3,000 for the taxpayer's contributions to an IRA.

The theory in setting these two-level limits is that, on the average, an employer contributes less than $1,500 to a qualified plan on behalf of an employee. For an employee in a low income bracket, an employer's contributions are probably much less than $1,500 but such an employee is most unlikely to be able to contribute anything like 15 percent/$1,500 anyway, so such limit is largely meaningless to such an employee. For an employee in a high income bracket, an employer contribution of $1,500 is probably about right on the average, so the differential of $1,500 between the two limits of 15 percent/$1,500 and 15 percent/$3,000 is about right.

Using these two-level limits keeps the mechanics very simple and, at the same time, quite reasonable. No one has to make an actuarial calculation. The IRS can easily control the deductions through the forms appended to Tax Returns.

(4) It is suggested that incorporating provisions in the qualified plan section of the Code for employee contributions to such plans is far simpler and more satisfactory than incorporating what would amount to qualified plan requirements into the IRA sections of the Code. Many of the restrictions that would need to apply to the employee's contribution are already embodied in the qualified plan sections.

There would need to be some amendments of the qualified plan sections, of course. For example, the following are some amendments that should be included:

(a) Immediate vesting of all benefits arising from employee contributions.

(b) No distributions from the employee's vested benefits arising from employee contributions while the employee is a participant in the qualified plan (i.e. the vested benefit from the employee's contributions would be "locked in" until the employee dies or terminates employment in the same way that the vested benefit from the employer's contributions is "locked in").

(c) Distributions from the two vested benefits would be made together in the same way at the same time and taxed in the same way. In other words, the total of the two vested benefits would be treated simply as distributions from the plan.

(d) The Joint and Survivor Annuity settlement would be required normally for both vested benefits at retirement.

(e) The special 10-year averaging method of taxation for lump-sum distributions would apply to both vested benefits.

(f) The rollover privilege to an IRA would apply to both vested benefits.

(5) It is suggested that Code Section 404(a) be amended to provide that an employee may secure tax deduction for contributions up to 15 percent/$1,500, subject to such limits applying to both contributions to the qualified plan and to any Regular IRA or Spousal IRA under Section 219 or 220. This limit would not be reduced by any employer contributions because the differential described earlier would take care of such an offset. (N.B. In conjunction with this amendment, Code Sections 219 and 220 would need to be amended to raise the limits for Regular IRA's to 15 percent/$3,000 and for Spousal IRA's to 15 percent/$3,500 or some such figure.)

(6) It is suggested that, if an employer so desires, a qualified plan could be designed to require employee contributions as a condition of employment or participation. The Code would be amended to permit required contributions of some specific percentage of compensation (e.g. 5 percent) up to a dollar limit of $1,500. If a taxpayer should already be contributing to an IRA, he would have to cut back on his IRA contributions if the two types of contributions would exceed the 15 percent/$1,500 limit. Such cutting back would be the responsibility of the taxpayer and would be controlled through the completion of a form like Form 5329.

(7) It is suggested that the qualified plan could permit optional contributions by the employee in addition to any mandatory contribution. The optional plus mandatory contribution to the qualified plan plus any IRA contributions would together have to be within the 15 percent/$1,500 limit.

(8) Insofar as their status as an employee in a Keogh Plan is concerned, a self-employed person would not be able to take deductions in respect to employee contributions. The 15 percent/$7,500 limit for self-employed persons is already sufficiently large.

Summary

Using the qualified plan route instead of the IRA or LERA route for contributions by active participants, means the following:

(a) In general, the normal requirements for qualified plans would apply to such contributions;

(b) There would be no problem with the discrimination question;

(c) The problem of an employee who has made a contribution to an IRA and becomes an active participant in a qualified plan in the same taxable year, would be overcome;

(d) Borderline employers would be encouraged to establish pension or profit-sharing plans for their employees instead of establishing IRA plans;

(e) Section 408(c) would still be available for an employer IRA plan if an employer does not want to establish a qualified plan;

(f) Allowing employees to secure tax deduction for contributions to a qualified plan, should prevent employees from opting out of the qualified plan in order to contribute to IRA's.

COSTS OF PENSION PLANS AND OTHER FRINGE BENEFITS, 1975

Class of industry [1]	Cost of all fringes per hour	Cost of all fringes per year	Average number of hours per year	Cost of all fringes as a percentage of payroll	Average annual compensation per employee	Cost of pensions as a percentage of payroll	Average annual cost of pensions per employee
Hospitals	$1.071	$2,201.7	2,055.7	24.0	$9,173.8	2.5	$229.4
Trade (Wholesale and some retail)	1.341	2,756.7	2,055.7	28.2	9,775.5	2.6	254.2
Department stores	1.055	2,230.4	2,055.7	28.4	7,853.5	2.7	212.1
Textiles, apparel	1.082	2,236.3	2,066.9	27.8	8,044.2	2.9	233.3
Pulp, paper, lumber, and furniture	1.637	3,383.5	2,066.9	32.7	10,347.1	3.5	362.2
Electrical equipment	1.869	3,863.3	2,066.9	35.0	11,038.0	3.8	419.4
Printing and publishing	1.778	3,674.9	2,066.9	32.2	11,412.7	4.1	467.9
Miscellaneous	2.069	4,253.2	2,055.7	32.2	13,208.7	4.2	554.8
Fabricated metal	1.827	3,776.2	2,066.9	35.1	10,758.4	4.4	473.4
Instruments and miscellaneous	1.771	3,660.5	2,066.9	34.8	10,518.7	4.4	462.8
Stone, clay, and glass	1.797	3,714.2	2,066.9	35.1	10,581.8	4.7	497.3
Machinery	1.974	4,080.1	2,066.9	36.1	11,302.2	4.7	531.2
Transportation equipment	2.240	4,629.9	2,066.9	39.9	11,603.8	5.3	615.0
Food, beverages, and tobacco	1.848	3,819.6	2,066.9	36.2	10,551.4	5.7	601.4
Banks, finance, trust	1.866	3,835.9	2,055.7	37.3	10,283.9	6.4	658.2
Chemicals, etc	2.395	4,950.2	2,066.9	42.2	11,730.3	6.5	762.5
Fiber, leather, plastic	1.901	3,929.2	2,066.9	40.4	9,725.7	6.7	651.6
Insurance	1.895	3,895.6	2,055.7	35.2	11,067.1	7.0	774.7
Primary metal	2.327	4,809.7	2,066.9	40.6	11,846.6	7.2	853.0
Public utilities	2,392	4,917.2	2,055.7	37.5	13,112.5	8.7	1,140.8
Petroleum	2.489	5,144.5	2,066.9	39.2	13.123.7	9.3	1,220.5
Manufacturing	1.913	3,954.0	2,066.9	36.1	10,952.9	4.9	536.7
Nonmanufacturing	1.958	4,025.0	2,055.7	34.4	11,700.6	6.9	807.3
Industries	1.952	3,984.0	2,062.1	35.4	11,254.2	5.5	619.0

[1] Industries are listed in order of the size of the percentages of payroll contributed for pension purposes.

Source: Tables from the U.S. Chamber of Commerce study on the costs of fringe benefits in 1975 as published in BNA Pension Reporter, Oct. 11, 1976.

Individual taxpayers grouped according to size of adjusted gross income

Size of adjusted gross income:	*Percentage of taxpayers below adjusted gross income level*
Under $5,000	34.2
Under $10,000	61.5
Under $15,000	81.3
Under $20,000	91.3
Under $25,000	95.3
Under $30,000	96.9
Under $50,000	98.7
Under $100,000	99.3

Source. Based on table 1.1 of statistics of income 1972, individual income tax returns, pub. 79 (1.75) issued by the Department of the Treasury, Internal Revenue Service.

CONTRIBUTIONS TO QUALIFIED PLANS AND IRA'S

[Basis: 1. Average employer contributions to qualified plans—5.5 percent of compensation. 2. Proposed limits for employee contributions of 15 percent/$1,500 for active participants for qualified plans plus IRA, and 15 percent/$3,000 for nonactive participants for IRA]

Annual compensation	Active participants (qualified plan plus IRA): Amount of maximum employee contribution	Maximum employee contribution [1]	Amount of average employer contribution	Average employer contribution [2]	Total amount [3]	Total average employer contribution [4]	Nonactive participants (IRA only): Amount [5]	Maximum employee contribution [1]
$5,000.....	$750	15.0	$275	5.5	$1,025	20.5	$750	15.0
$8,000.....	1,200	15.0	440	5.5	1,640	20.5	1,200	15.0
$10,000....	1,500	15.0	550	5.5	2,050	20.5	1,500	15.0
$12,000....	1,500	12.5	660	5.5	2,160	18.0	1,800	15.0
$14,000....	1,500	10.7	770	5.5	2,270	16.2	2,100	15.0
$15,000....	1,500	10.0	825	5.5	2,325	15.5	2,250	15.0
$16,000....	1,500	9.4	880	5.5	2,380	14.9	2,400	15.0
$18,000....	1,500	8.3	990	5.5	2,490	13.8	2,700	15.0
$20,000....	1,500	7.5	1,100	5.5	2,600	13.0	3,000	15.0
$22,000....	1,500	6.8	1,210	5.5	2,710	12.3	3,000	13.6
$24,000....	1,500	6.3	1,320	5.5	2,820	11.8	3,000	12.5
$26,000....	1,500	5.8	1,430	5.5	2,930	11.3	3,000	11.5
$28,000....	1,500	5.4	1,540	5.5	3,040	10.9	3,000	10.7
$30,000....	1,500	5.0	1,650	5.5	3,150	10.5	3,000	10.0
$32,000....	1,500	4.9	1,760	5.5	3,260	10.4	3,000	9.4
$34,000....	1,500	4.4	1,870	5.5	3,370	9.9	3,000	8.8
$36,000....	1,500	4.2	1,980	5.5	3,480	9.7	3,000	8.3
$38,000....	1,500	4.0	2,090	5.5	3,590	9.5	3,000	7.8
$40,000....	1,500	3.8	2,200	5.5	3,700	9.3	3,000	7.5
$42,000....	1,500	3.6	2,310	5.5	3,810	9.1	3,000	7.1
$44,000....	1,500	3.4	2,420	5.5	3,920	8.9	3,000	6.8
$46,000....	1,500	3.3	2,530	5.5	4,030	8.8	3,000	6.5
$48,000....	1,500	3.1	2,750	5.5	4,140	8.5	3,000	6.0
$50,000....	1,500	3.0	2,750	5.5	4,250	8.5	3,000	6.0
$60,000....	1,500	2.5	3,300	5.5	3,800	8.0	3,000	5.0
$75,000....	1,500	2.0	4,125	5.5	5,625	7.5	3,000	4.0
$100,000...	1,500	1.5	5,500	5.5	7,000	7.0	3,000	3.0

[1] As a percentage of compensation.
[2] As a percentage of compensation. Average percentage of 5.5 is based on tables from the U.S. Chamber of Commerce study on the costs of fringe benefits in 1975.
[3] Of average employee contribution and maximum employee contribution.
[4] Plus maximum employee contribution as a percentage of compensation.
[5] Of maximum employee contribution to an IRA.

INDIVIDUAL RETIREMENT ACCOUNTS FOR ACTIVE PARTICIPANTS

(BY JOHN S. RYBKA)

Enclosed are my suggestions with respect to amending the Internal Revenue Code to permit individuals who are active participants in a qualified plan to establish Individual Retirement Accounts.

In essence, these recommendations are geared to provide a simple, understandable and administerable plan scheme to encourage all working individuals in the private sector to save a portion of their earnings (tax-free) for their retirement years.

Congressional intent

Given the premise that Congress is still eager to encourage individual taxpayers in the private sector to save for retirement during their income-producing years, it would appear that the next most logical step in the area of Individual Retirement Accounts (IRAs) would be to permit individuals to establish IRAs, irregardless of whether they are active participants in a qualified plan or trust.

As implied by the meetings surrounding the passage of the Tax Reform Act of 1976 (Public Law 94-455), this concept of IRAs for active participants should be one that is understandable to all, non-burdensome to employers, and of course, practical in operation.

Major consideration—discrimination

The recommendation that a two-level limit of 15 percent/$1,500 for active participants and 15 percent/$3,000 for those who are not active participants is a sound and equitable theory. However, the suggestion that employee contributions (both voluntary and mandatory) to a qualified plan be tax deductible is, unfortunately, discriminatory in favor of the higher-paid individual taxpayer. Given the fact that lower-paid individuals must rely on their earnings to purchase consumer products, the possibility that these individuals will set aside earnings for retirement is, in reality, purely academic.

However, on the other side of the coin, a higher-paid individual who would be permitted to make tax deductible contributions to his or her employer's qualified plan, most likely would take advantage of such a tax break, the main reason being that this type of individual would have more disposable income. I submit, therefore, that such a scheme is none other than a tax loop-hole favoring only the highly compensated individual.

Recommendation—IRA based on compensation

Keeping the concept of discrimination in mind, I would like to submit the following suggestions for granting tax deductions for contributions to an individual retirement savings program, based upon compensation, irregardless of whether an individual is an active participant in a qualified plan.

(1) Establish a two-tiered contribution limit scheme, whereby an individual who is not an active participant in a qualified plan may set aside and deduct up to 15 percent of his or her compensation, with a maximum of $3,000 per calendar year. If an individual is an active participant in a qualified plan, he or she may also establish an IRA and deduct up to 15 percent of his or her compensation, with a maximum of $1,500 per calendar year.

(2) In order to avoid discrimination in favor of the highly-compensated individual who is an active participant, the $1,500 tax deductible limit to the IRA would decrease as the individual's compensation increases above the $15,000 level. Thus, for each $1,000 of earnings above the $15,000 level, the tax deductible contribution would decrease $100. So, for an individual whose Form W-2 shows earnings of $30,000 or more, his or her contribution to an IRA would be $0. The following chart shows this plan set-up:

IRA for active participants

	Allowable contribution		Allowable contribution
Compensation level:		Compensation level:	
$1,000	$150	$16,000	$1, 400
$2,000	300	$17,000	1, 300
$3,000	450	$18,000	1, 200
$4,000	600	$19,000	1, 100
$5,000	750	$20,000	1, 000
$6,000	900	$21,000	900
$7,000	1, 050	$22,000	800
$8,000	1, 200	$23,000	700
$9,000	1, 350	$24,000	600
$10,000	1, 500	$25,000	500
$11,000	1, 500	$26,000	400
$12,000	1, 500	$27,000	300
$13,000	1, 500	$28,000	200
$14,000	1, 500	$29,000	100
$15,000	1, 500	$30,000 or more	0

(3) It is further recommended that as the individual's compensation exceeds $15,000, it be rounded off to the nearest $100 so that the chart (above) may be interpolated to permit the following:

(a) A Form W-2 which shows $17,625.75 as earnings, would be rounded off to $17,600 for purposes of determining the IRA contribution. In this particular case, then, a tax deductible contribution of $1360 may be made to an IRA.

(4) This plan scheme would accomplish the following:

(a) the possibility of a lower-paid individual being able to save for retirement if she or he is so inclined;

(b) less discrimination in favor of the higher-paid individual who can easily afford to make contributions and who could take greater advantage of the tax deduction;

(c) a simple scheme which can be understood by all; and

(d) a scheme which can be easily administered by the IRS.

(5) The obligation for determining how much the individual could contribute to the IRA would be solely the responsibility of the particular individual. Neither the employer nor the trustee or custodian of the IRA account would be responsible or liable for the individual's actions.

(6) Form 5329, Return for Individual Retirement Savings Arrangements, could easily be revised by the IRS to show the two-tiered dollar limits and the interpolated chart for those individuals who are active participants in a qualified plan and whose Form W-2 (wages and/or compensation) exceeds $15,000.

IRA's for the non-working spouse

The 15 percent/$1,750 limits of Code Section 220 should be amended. Since, at present (actually, beginning in 1977) there is an additional $250 that a working individual can set aside for his or her non-working spouse, this basic concept should be allowed to continue, no matter what a particular individual shows as compensation or self-employment income. Thus, I recommend the following changes:

(1) Although a self-employed individual may establish a Keogh plan (15 percent/$17,500 limits), he or she should be permitted to establish an IRA for his or her spouse, if that spouse is non-working. Given the present differential of $250 an IRA could be established, with annual tax-deductible contributions of not more than $250 from self-employment income being made to the account. In this particular instance, however, the 50:50 split required by Code Section 220 should not be imposed upon the Keogh IRA. Rather, the entire $250 would be owned and controlled by the non-working spouse.

(2) For an individual-employee who is not an active participant, a 15 percent/ $3,250 limit would be applied.

(3) For an individual-employee who is an active participant in a qualified plan, a 15 percent/$1,750 limit would be applied. However, for each $1,000 that an individual's compensation exceeds $15,000, the $1,750 limit would be reduced by $100, so that at the $30,000 compensation level, the individual would be permitted to set aside up to $250 per year, if his or her spouse is non-working.

As a result, the interpolated chart described earlier would read as follows:

Compensation level	Allowable IRA contribution 15 percent/$1,500	Allowable spousal IRA contribution 15 percent/$1,750
$1,000	$150	$150
$2,000	300	300
$3,000	450	450
$4,000	600	600
$5,000	750	750
$6,000	900	900
$7,000	1,050	1,050
$8,000	1,200	1,200
$9,000	1,350	1,350
$10,000	1,500	1,500
$11,000	1,500	1,650
$12,000	1,500	1,750
$13,000	1,500	1,750
$14,000	1,500	1,750
$15,000	1,500	1,750
$16,000	1,400	1,650
$17,000	1,300	1,550
$18,000	1,200	1,450
$19,000	1,100	1,350
$20,000	1,000	1,250
$21,000	900	1,150
$22,000	800	1,050
$23,000	700	950
$24,000	600	850
$25,000	500	750
$26,000	400	650
$27,000	300	550
$28,000	200	450
$29,000	100	350
$30,000 or more	0	250

(4) The 50:50 split in a Spousal IRA combination should be maintained. This is because the contributions which are allocated to the non-working spouse's account are owned and controlled by that spouse. As a result, upon the death of the working spouse, that portion under the control of the non-working spouse is not includible in the decedent's gross estate for federal estate tax purposes. It follows, then, that any deviation from the 50:50 split in favor or the non-working spouse would be nothing more than an estate tax avoidance scheme on the part of the working spouse.

Earlier in my recommendations, I made note that a Keogh IRA need not follow the 50:50 split requirements of Code Section 220. The reasoning behind this relates to the fact than a Keogh IRA; that is, the $250 limit, would either increase the $7,500 Keogh limit to $7,750 or be considered an entirely separate retirement savings plan. In either case, the $250 would be owned and controlled only by the non-working spouse. My intentions here are not to create a $7,625 Keogh limit and a $125 Keogh IRA, totalling $7,750.

Obviously, since this is only a preliminary draft, the details have not as yet been finalized. However, if the concept is acceptable, then more work will have to be done in respect to the estate tax consequences of a Keogh IRA if the 50:50 split requirement is not adhered to.

Conclusion

In conclusion, then, this scheme, which will permit tax deductible contributions to be made to an IRA by an active participant, is not only feasible, but very practical and equitable. It basically accomplishes two major goals: while it encourages a middle- to lower-paid active participant to save for retirement, it is equitable in that it does not afford a higher paid individual to take advantage of the tax deduction.

According to the Tables from the U.S. Chamber of Commerce Study on the Costs of Fringe Benefits in 1975; the cost of pensions to employers per employee as a percentage of payroll (for all industries) was 5.5 percent. If we applied this percentage to an individual who earns $30,000 per year, we get $1,650; to an individual who earns $10,000 per year, it is $550. Although the interpolated charts (above) do not, dollar-for-dollar, make up the difference between the two figures, that is really not the point at issue. In reality, it is quite obvious that an individual earning in excess of $30,000 per year, economically speaking, is in better financial position to make a contribution (whether or not it is tax deductible) than an individual earning $10,000 to $15,000 per year.

As a result, I strongly recommend a plan scheme which, at least, offers a tax deduction to those who need it most—the lower and middle income taxpayers.

Addendum to Brief Submitted in Respect to Individual Retirement Accounts for Active Participants

The following suggestions relate to the need for amending the Internal Revenue Code to redefine the term "active participant" in accordance with a particular plan's vesting schedule.

It is intended that this addendum be incorporated into the original proposal regarding "Individual Retirement Accounts for Active Participants".

Vesting and benefit accrual

As you know, one of the evils that Congress corrected when it enacted ERISA was that of the treatment of a long-term employee who separated from service of the employer prior to the time when he or she would be entitled to retirement benefits. Generally speaking, a pre-ERISA employee's right to retirement benefit became nonforfeitable at the time the individual was eligible to receive the benefit, unless the IRS imposed earlier vesting to prevent discrimination in favor of the prohibited group or in the event of plan termination.

Because of ERISA, pension rights now become nonforfeitable (via vesting) schedules at no less than specified rates during the employee's service career with the employer. Of course, vesting per se will not render a retirement benefit for an employee unless he or she is vested in a benefit which accrues year by year during the employment period. ERISA imposes various alternative benefit accrual standards to guarantee some uniform system of accrued benefit.

Long-term vs. short-term employee

ERISA, in operation, clearly protects the long-term employee from a total loss of pension benefits, should termination of employment, disability, death or early retirement occur. The problem, however, is in respect to the short-term employee. Depending, of course, on the employer's vesting schedule, as found in the plan, ERISA offers little or no protection for them.

Let's take a look at a typical situation. Assume an employee, who after one year of service with the employer becomes an active participant (eligible) in a non-contributory defined benefit or contribution plan. Assume further that the plan calls for the 10-year vesting rule. In this particular situation, although employer contributions may be accruing year after year, the employee will have no vested interest in that accrued benefit until he or she has attained 10 years of service (at which time he or she will be 100 percent vested in the accrued benefit). As a result, termination from 1 to 9 years of service would render a retirement benefit of $0.

Whatever vesting and accrual standards are used, there will always be a period of time during which termination of service would result in a retirement benefit of $0, even under the IRS' 4/40 vesting rule. Obviously, 100 percent vesting upon entry into the plan is an exception to this generality.

My point is simply this: Moving from one opportunity to another as many as 3 to 5 or more times within a 10- to 15-year employment period is not uncommon. Result? A short-term employee not protected at all by ERISA.

It is quite possible, then, that an individual may be employed within the private work force with various employers for many years, with little or no retirement benefits being credited toward that individual's retirement years.

Solution to the short-term problem

Under the law and regulations as they presently exist, an "active participant" in certain plans is not permitted to establish an IRA. Generally speaking, an individual is deemed an active participant in a plan for a particular taxable year if:

1. In the case of a defined benefit plan, benefits are accrued on his or her behalf, or
2. In the case of a money purchase plan, the employer is obligated to contribute to the plan on behalf of the individual, or
3. In the case of a profit-sharing plan, the employer would be obligated to contribute on the individual's behalf, if any contributions are made to the plan.

Furthermore, the regulations state that an individual will be deemed an active participant regardless of whether or not his or her benefits under the plan are nonforfeitable (Prop. Reg. 1.219–1(c)(1)(ii)(A)).

My first proposal, extending IRAs to active participants, helps to ease this inequity by use of a two-tiered IRA contribution limit of 15 percent/$3,000 for those not active participants and 15 percent/$1,500 for those who are active participants. Under the original proposal, the $1,500 deductible IRA limit would decrease as the indiviual's compensation rises above the $15,000 level, so that at $30,000, the contribution to an IRA would be $0. As explained in the earlier brief, the purpose of a decreasing IRA contribution limit for an active participant is to avoid discrimination in favor of the highly-compensated individual.

Unfortunately, unless and until the term "active participant" is redefined, this so-called active participant IRA concept would discriminate in favor of the long-term employee.

Discrimination and the long-term employee

If the two-tiered IRA system is accepted, a question which must be answered is still: "Who is an Active Participant?" If the same definition, as used in the IRS proposed regulations, applies, then discrimination in favor of the long-term (and probably the highly-compensated) individual would result.

As you can easily see, a younger individual who may possibly move to, say, 3 different jobs within a 15-year period would, under the proposed regulations, be deemed an active participant after entry into each plan, which in most cases is one year. If we apply the two-tiered IRA system, this particular employee would be entitled to establish an IRA and contribute up to 15 percent/$3,000 for his or her first year of service. But, upon entry into the plan, he or she would be eligible to contribute a maximum of only 15 percent/$1,500 even though he or she may or may not be vested in the employer's accrued benefit.

Redefine "active participant"

To alleviate any and all inequities, an individual should be permitted and encouraged to establish and maintain an IRA at the 15 percent/$3,000 level until and at such time that an accrued benefit becomes vested. At this point, the 15 percent/$1,500 limits should come into play.

If we go back to the first example in this addendum, an employee who is an active participant in a non-contributory qualified plan would, after 5 years of service, have no vested interest in the amounts allocated on his or her behalf. Yet, under the original proposal and because of the existing definition of "active participant", this individual would be tied to the 15 percent/$1,500 limits.

Thus, to make the proposal more equitable, I submit that the term "active participant" be re-defined so that an individual would be deemed an active participant in a qualified plan at such time that he or she becomes vested in the employer contributions (no matter what schedule is used). By doing this, we at least offer that short-term employee the opportunity to save for retirement—a situation that does not exist under present law, because of a plan's particular vesting schedule and because of the definition of active participant as it now exists.

Recordkeeping and reporting requirements

The employee, through various employee benefit booklets as well as the summary plan description, would be fully aware of the vesting schedule provided for in his or her employer's plan. The IRS, by simply revising Form 5329, could require the individual to check the appropriate vesting schedule "box" listed on the return, and to reveal his or her employment (hire) date. Through this information, the IRS would be able to determine the exact status of the individual's permissable IRA contribution deduction.

If needed, cross-checking could be accomplished by:

1. Revising Form 5500 Series to require the plan administrator to disclose the type of vesting schedule used, or
2. Require that copies of Form EBS-1, which is filed with the Labor Department, also be filed with the IRS, and
3. Reflecting on Form W-2, the years of service an employee has with respect to that particular employer.

Summary

This addendum, therefore, proposes to do the following:

1. Extend the protection of employee benefits by ERISA to short as well as long-term employees.
2. Redefine "active participant" in a qualified plan to mean one who has a vested interest in an accrued benefit.
3. Extend the original proposal of 15 percent/$3,000 IRS limits to individuals who are participants under a qualified plan, but who do not, as yet, have a vested interest in a retirement benefit under the plan.

Employee becoming an active participant

Under Code Section 219(b)(2), no deduction is permitted in respect to a contribution made in a taxable year of an individual in which he becomes an active participant in a qualified plan, etc. This means that, even though the individual is a participant for only 1 day in his taxable year, he loses 100 perecent of his deduction. This is unduly harsh. I suggest that the Code be amended so that he loses only the part of his deduction proportionate to the part of the taxable year that he is an active participant.

Endowment contracts under IRA accounts

Under Code Section 408(b), an endowment contract that meets the definition contained in the last sentence of the section can be used as an IRA ANNUITY. When such a contract is used, the premium for it must not exceed $1,500 and the premium must be split into its "savings element" and its "cost of insurance element" according to IRS rules. The savings element becomes the deductible IRA contribution. This is no problem and is a procedure that has been used for qualified pension plan business for many years.

Under Code Section 408(a)(3), it is stated that no trust funds may be invested in "life insurance contracts". This is generally interpreted to mean that contracts such as a "Whole Life Policy" cannot be used as investment vehicles. This is logical and not objectionable. However, if an endowment insurance contract can be considered to be an annuity contract under Section 408(b), it is logical to conclude that an endowment should be considered to be an annuity contract under Section 408(a).

To a degree, this logic seems to be accepted because Section 408(e)(5) does assume that an endowment insurance contract can be used under Section 408(a).

However, instead of allowing the premium under such a contract to be split as described in the first paragraph above, Section 408(e)(5) states that the savings element must be treated as a rollover contribution. For an ongoing IRA with annual contributions, it is illogical to treat part of the annual contribution as a rollover contribution. The effect of the restrictions in Section 408(e)(5) is that an endowment insurance contract cannot be used under an IRA ACCOUNT under Section 408(a).

It is suggested that Section 408(e)(5) be deleted from the Code and that the introductory sentence of Section 408(a) be amended to read along the lines of the introductory sentence of Section 408(b) so as to permit annuity contracts and endowment insurance contracts to be used among the investment vehicles available under an IRA ACCOUNT. Or, alternatively, perhaps Section 408(a)(3) could be amended to read as follows:

> (3) No part of the trust funds will be invested in life insurance contracts, except annuity contracts and endowment contracts that meet the requirements specified in Section 408(b).

Exclusion from income tax for IRA death benefit

Under Code Section 101(b), a death benefit arising out of a qualified plan is entitled to a $5,000 exclusion from income tax (except in the case of a self-employed person under a Keogh Plan).

It is suggested that a similar exclusion be extended to a death benefit arising out of an IRA. This is somewhat analogous to extending the estate tax exclusion to such a death benefit as was done by Section 1501 of the Tax Reform Act of 1976.

Borrowing under an IRA annuity

Code Section 408(e)(3) provides that, if a loan is taken against an IRA annuity or if an IRA annunity is used as security for a loan, then the IRA annuity ceases to be an IRA so that the fair market value of it is considered to be a lump-sum distribution subject to tax as of the beginning of the current taxable year of the taxpayer.

On the other hand, Code Section 408(e)(4) provides that, if a loan is taken against an IRA account or if an IRA account is used as security for a loan, then an amount equal to the loan is considered to be a lump-sum distribution subject to tax apparently as of the date of the loan. The remainder of the IRA account continues to be accepted as an IRA.

There seems to be no logical reason for this discrimination against the IRA annuity.

IRS form 5498

Form 5498 is used by insurance companies, banks, savings and loan associations, mutual fund companies, credit unions, etc., to report to the IRS each year on the transactions that have occurred during the calendar year under each IRA on their books. Under the Proposed Regulations which were issued in February 1975, but not yet finalized, Section 1.408–1(d)(2) requires Form 5498 to be completed within 30 days after the close of the individual's taxable year, which normally means by January 30.

The Tax Reform Act of 1976 has amended the Code by the edition of Code Sections 220(c)(4) and 219(c)(3) so that a carryback period of 45 days is available for an individual to make a contribution to an IRA and have the contribution counted for his or her preceding taxable year. This means that a contribution can be paid anytime up to and including February 14.

Complying with the January 30 deadline has been difficult because of the time lag that occurs in passing a contribution payment made on December 31 through the mails and accounting procedures. Now that the date has been changed from December 31 to February 14, I suggest that the deadline date for completion of Form 5498 be moved to March 31 each year.

This would mean amending Proposed Regulation 1.408–1(d)(2) insofar as 1977 contributions are concerned at least. If the suggestion made to the IRS by Representative Charles A. Vanik is adopted and the 45-day carryback period is made available administratively for 1976 contributions, then the change would be desirable for 1976 contributions.

Mini IRA

Code Section 404(e)(4) permits a self-employed person to establish a Keogh plan under which the contribution limit can be $750 or 100 percent of earned income, whichever is the lesser. Under this provision, it is possible for a person who is a self-employed person on a part-time basis while normally a regular employee of a corporation to set aside some or all of his part-time earnings as savings for retirement.

I suggest that a similar provision be included in the Code to permit an employee who is participating in a qualified plan to set aside in an IRA his or her part-time earnings from another source up to a limit similar to that for a Mini-Keogh as described above.

Revocation of an IRA

In December, 1975, the IRS issued TIR1425, which stated that, if an IRA started in 1975 was revoked on or before April 15, 1976, the full contribution could be refunded without tax penalty. At the same time, the IRA stated that "in general, the final regulations will provide certain rules having the effect of permitting the individual who establishes but later revokes the account, annuity or contract to treat for tax purposes the account, annuity or contract as though it had not been established". To date, the IRS has not issued final regulations. Proposed regulations for IRA's were issued in February, 1975, but have not been put out in final form.

It is suggested that the IRS issue the final IRA regulations or, if that is not feasible, a new TIR along the lines of TIR1425.

Also, it is suggested that, in such regulations or such TIR, the IRS define what constitutes a revocation and what circumstances can permit a revocation.

Excess contributions

Three sections of the Code deal with the question of excess contributions, 408(d)(4), 4973(a) and 4973(b). The latter two sections were amended by the Tax Reform Act with the intention of clarifying the procedures and the application of the 6% excise tax penalty. Unfortunately, there still remains a lack of clarity.

Appended to this memorandum is an excerpt from an IRA Manual which is intended to describe the procedures for handling excess contributions. However, I am not certain that the description is fully accurate.

I suggest that the three sections referred to above, be given further consideration with a view to making them clearer.

PART XIV—EXCESS CONTRIBUTIONS

Types of Excess Contributions

An excess contribution can occur in many ways, as we have described in Parts IV and X. The following is a listing of the different ways:

In Part IV

(1) A contribution made within a taxable year of an individual may exceed $1500 or 15 percent of the individual's compensation or earned income. In this case, the excess contribution is the amount in excess of the lesser limit.

(2) An individual may become an active participant in a qualified plan, a 403(b) plan or a government retirement plan within the same taxable year of the individual in which he or she made a contribution. In this case, the excess contribution is the whole of the contribution.

(3) An individual may make a contribution within the same taxable year in which he or she attains age 70½ or in a subsequent taxable year. In this case, the excess contribution is the whole of the contribution.

In Part X

(4) A contribution made within a taxable year of a working spouse may exceed $1,750 or 15 percent of the compensation or earned income of the working spouse. In such case, the excess contribution is the amount in excess of the lesser limit.

(5) A contribution made into a Regular IRA or a Spousal IRA under a Spousal IRA Combination, may be in excess of 50 percent of the total contribution for the Spousal IRA Combination. In this case, the excess contribution is equal to twice the amount in excess of 50 percent of the total contribution to the Spousal IRA Combination.

(6) A working spouse may make a contribution to a Spousal IRA Combination within the same taxable year in which he or she attains age 70½ or in a subsequent taxable year. In this case, the excess contribution is the whole of the contribution to the Spousal IRA Combination.

(7) A working spouse may make a contribution to a Spousal IRA for his or her non-working spouse within the same taxable year in which the non-working spouse attains age 70½ or in a subsequent taxable year. In this case, the excess contribution is the whole of the contribution for the Spousal IRA.

(8) A working spouse may become an active participant in a qualified plan, a 403(b) plan or a government retirement plan within the same taxable year of the working spouse in which he or she has made a contribution to a Spousal IRA Combination. In this case, the excess contribution is the whole of the contribution to the Spousal IRA Combination.

(9) A working spouse may make a contribution to a Spousal IRA within the same taxable year of the working spouse in which the non-working spouse receives some compensation or earned income. In this case, the excess contribution is the whole of the contribution for the Spousal IRA.

Penalty tax

If the excess contribution remains in the IRA and is not disposed of by one of the methods described below, a 6 percent excise tax is imposed in each and every taxable year that the excess remains in the IRA. Such tax is payable by the individual establishing an IRA annuity or an IRA account or by the working spouse establishing a Spousal IRA Combination. An employee or a member for whom an account is maintained in an IRA plan is considered to be such an individual.

This excise tax is not deductible from the gross income of the individual or working spouse. The excise tax is imposed even if the assets in the IRA have reduced since the payment of the excess contributions. However, the excise tax is not permitted to exceed 6 percent of the amount of such assets.

Refunding an excess contribution

Under Types (1), (3), (4), (5), (6), (7) and (9) above, Code Section 408(d)(4) provides that, if the excess contribution is refunded to the individual or the working spouse on or before the filing date of his or her tax return, then no excise tax penalty is imposed.

However, Code Section 4973(b)(2) as amended by the Tax Reform Act seems to override the terms of Section 408(d)(4) to some extent. If the contribution is in excess of $1,500 (or $1,750), then apparently the excess over such dollar limit is still subject to the excise tax penalty even though it is refunded on or before the tax filing date. We shall have to wait the issuance of regulations to clear up this point.

Under Types (2) and (8) above, Code Section 4973(b)(2) states that the full amount of the contributions are considered to be "amounts not contributed", providing the contributions are refunded under Code Section 408(d)(4) to the individual or the working spouse on or before the filing date of his or her tax return. If properly refunded, then no excise tax penalty is imposed.

No deduction is allowed for a refunded contribution or excess contribution, of course. However, if the contribution or excess contribution has acquired some investment earnings while in the IRA, such earnings have to be included in the gross income of the individual or working spouse for the taxable year in which the earnings are received.

A possible alternative disposition

Instead of refunding the excess contribution as described above, some authorities feel the excess may be applied to the allowable contributions of the next taxable year. For example, if the excess contributions were made in the 1977 taxable year in lieu of having the excess refunded to the individual in the period before 1977 income tax return is filed, it is believed the individual could instruct the life insurance company, the trustee or the custodian to retain the excess in the IRA and to consider the excess as a payment on account of his or her contributions for the 1978 taxable year.

If this procedure is used, the individual may claim no deduction for the excess in respect to the 1977 taxable year. However, the tax penalty described above is avoided and the individual is able to claim a deduction for the excess in 1978—provided, of course, the total contributions for the 1978 taxable year (including the excess) do not exceed the 15 percent/$1,500 limitation or the 15 percent/$1,750 limitation.

Delayed disposition

If the excess contribution is not forthwith disposed of under either of the two methods described above and instead is left in the IRA, the penalty tax of 6 percent is imposed each and every year thereafter until the excess contribution is disposed of. Moreover, if the excess contribution plus investment earnings are later refunded, the contributions and earnings are considered to be a distribution from the IRA and are included in the recipient's gross income as described in Part XV. If such distribution occurs before age 59½ of the individual or working spouse, the distribution is considered to be a premature distribution and subject to an additional 10 percent tax penalty as described in Part XVII.

Except when the contribution exceeds $1,500 (or $1,750), an insurance company, trustee or custodian will not know whether an individual or a working spouse has contributed an excess amount. Therefore, the onus is on the individual or working spouse to inform the insurance company, trustee or custodian. Failure to give such notice in sufficient time would cause the 6 percent penalty tax to be imposed.

Reapplying excess contributions

Under Code Section 408(d)(4) there is permission for an excess contribution to be refunded to the taxpayer if it is refunded prior to tax filing date.

It is suggested that Section 408(d)(4) be amended to permit an excess contribution to be applied on account of the contribution payable in the taxable year next succeeding the taxable year with respect to which it was paid. Such application could be made by the insurance company, bank, savings and loan association, mutual fund company, credit union, etc., on written instruction from the taxpayer. Such reapplied contribution would have to be considered to be a regular contribution after it is reapplied and would be deductible if it (together with any new money contributed) were within the 15 percent/$1,500 or 15 percent/$1,750 limits.

Such permission would provide a much simpler and more satisfactory method of disposing of an excess contribution. Any investment earnings that had accrued to the excess contributions could be similarly applied. Such earnings are taxable when paid out in the same way that accruals from contributions are taxable, so there is no reason why such earnings could not be applied on account of contributions for the next ensuing taxable year.

Requirements for spousal IRA

The Tax Reform Act added Section 220 to the Code to permit the purchase of Spousal IRA's. In order to define the restrictions and requirements applicable to such IRA's, Code Section 220(a) in Subsection (1) and (2) states that the requirements listed in Code Sections 408(a) and 408(b) are to be applicable to an IRA account and an IRA annuity, respectively. Basically, this is logical but, unfortunately, Sections 408(a)(1) and 408(b)(2) state that the contributions and premiums, respectively, are not to exceed $1,500; whereas, under Code Section 220(b)(C) the dollar limit is $1,750.

Presumably, this was a drafting error.

Contributions for spousal IRA combination

Under Code Section 220(b)(1), in order for a working spouse to obtain the maximum deduction within the 15 percent/$1,750 limit, it is necessary for contributions to be split exactly 50:50 between a Regular IRA and a Spousal IRA. If more than 50 percent is contributed to either a Regular IRA or a Spousal IRA, then Section 220(b)(1)(A) has the result of treating twice the amount of the excess over 50 percent as an excess contribution subject to 6 percent penalty in addition to being not deductible.

Since the whole purpose of Section 220 is to encourage a working spouse to set aside savings for his or her non-working spouse, it does not seem reasonable that the working spouse should be penalized for attempting to set aside as much savings for the non-working spouse as possible. Therefore, it is suggested that Section 220(b)(1) be amended to permit the non-working spouse to secure deductions for contributions to a Spousal IRA for the non-working spouse for any amount up to the full 15 percent $1,750.

Any excess over 50 percent contributed to a Regular IRA under a Spousal IRA Combination could be treated as an excess contribution under Section 220(b)(1)(A), but the contributions for a Spousal IRA under a Spousal IRA Combination would not be so treated and, in fact, up to a full 100 percent of the 15 percent/$1,750 could be contributed to the Spousal IRA without penalty.

The following table demonstrates the application of Section 220(b)(1) as it now stands:

Total contributions	Contributions to regular IRA owned by working spouse	Contributions to spousal IRA owned by non-working spouse	Total deductions permitted	Excess contributions
$1,750	$500	$1,250	$1,000	$750
$1,750	700	1,050	1,400	350
$1,750	875	875	1,750	
$1,750	900	850	1,700	50
$1,750	1,100	650	1,300	450
$1,750	1,300	450	900	850
$1,750	1,500	250	500	1,250

Estate tax exclusion for spousal IRA

Section 2008 (originally 2208) of the Tax Reform Act amended Code Section 2039 by adding Subsection (e) which provides for an exclusion from estate tax for the death benefit under an IRA purchased under Section 219. Unfortunately, Section 2039(e) does not provide for a similar exclusion for the death benefit under a Spousal IRA purchased under Section 220.

Right of survivorship under spousal IRA combinations

Under the Statement of the Managers following the Conference Committee work on the Tax Reform Act of 1976, it was stated in connection with Section 1501 of the Act that an IRA account could be established for a Spousal IRA Combination and that under Regular IRA for the working spouse and one for the Spousal IRA for the non-working spouse. Although the IRA account cannot be owned jointly, the Statement of the Managers does state that "each spouse could have a right of survivorship with respect to the subaccount of the other".

There appears to be nothing in Code Section 220 as added to the Code by the Tax Reform Act that makes provision for either the two subaccounts or the right of survivorship. I suggest that Section 220 should be amended to include such provision.

In addition, there seems to be no reason why the "right of survivorship provision" should not be available for other types of IRA's used for a Spousal IRA Combination. For example, if two IRA annuities were established for the Regular IRA and the Spousal IRA, it is suggested that Section 220 should provide for a "right of survivorship provision" to be included in each IRA annuity.

Existing IRA for spousal IRA combination

If a working spouse has already established a Regular IRA under the terms of Section 219 of the Code and wishes to establish a Spousal IRA for his or her non-working spouse, Section 220 does not make it clear that he can use his existing IRA.

It is suggested that Code Section 220 be amended to permit the use of an existing Regular IRA in conjunction with a new Spousal IRA, providing the Regular IRA is amended as necessary to suit the provision of Section 220. For example, the contributions to the Regular IRA would have to comply with the terms of Code Section 220(b)(1) which, in effect, requires a 50 : 50 split in contributions between the Regular IRA and the Spousal IRA (unless Section 220(b)(1) is amended as suggested elsewhere).

Rollover from qualified plan to an IRA

Code Sections 402(a)(5) and 403(a)(4) permit lump-sum distributions from qualified plans to be rolled over into Rollover IRA's. For this purpose, reference is made to Section 402(e)(4) for a definition of "lump-sum distribution". This is fine except that Section 402(e)(4) contains a subsection (H) which states that a participant must have a minimum of 5 years of participation in order to qualify for a lump-sum distribution.

The basic purpose of Section 402(e)(4) is to define "lump-sum distribution" in respect to the special 10-year averaging procedure for taxing a lump-sum distribution which was introduced by ERISA. Perhaps for that purpose the 5-year participation requirement is justified.

However, there seems to be no reason for a five-year participation requirement being applied to the rollover privilege. It is probable that Congress did not consider this point when it used Section 402(e)(4) as a source of a definition of a "lump-sum distribution".

Rollover of "property" from a qualified plan to an IRA

Code Sections 402(a)(5) and 403(a)(4) in Subsection (C) require that, if a lump-sum distribution from a qualified plan consists of "property (other than money)", such property is what must be transferred into the IRA. This requirement restricts the rollover provision considerably. For example, if an employee terminating employment at retirement or earlier, received a lump-sum distribution in the form of stock or partly money and partly stock, he would not be able to transfer the distribution to an insurance company to buy an IRA annuity because an insurance company cannot receive stock as a premium. Therefore, if the employee wanted to convert his lump-sum distribution into a retirement income, he would not be able to do so.

Public Law 94-267 in Section (d)(2) recognized this problem of converting stock into money when the stock had been received and sold prior to the enactment of Public Law 94-267. An employee, in event of such a sale, is permitted to "transfer an amount of cash equal to the proceeds received from the sale or exchange of such property in excess of the amount considered contributed by the employee".

It is suggested that Sections 402(a)(5)(C) and 403(a)(4)(C) be amended to contain a similar provision for sale or exchange of property.

Rollover of death under a qualified plan

Code Sections 402(a)(5) and 403(a)(4) permit a lump-sum distribution that is paid to an employee to be rolled over into an IRA. The two sections refer to Code Section 402(e)(4) for a definition of a lump-sum distribution. Section 402(e)(4)(A) lists the events that can result in a lump-sum distribution. Included in the list is a distribution made "on account of the employee's death". On the face of it, it would seem that a lump-sum death benefit could be rolled over to an IRA by the recipient of it.

However, both Sections 402(a)(5) and 403(a)(4), as originally contained in ERISA and as amended by Public Law 94-267 on April 15, 1975, contain the words "the balance to the credit of an employee is paid to him". The result of this wording is that a beneficiary receiving a lump-sum distribution is not entitled to roll it over into an IRA.

I suggest that there are situations where it would be quite desirable for a beneficiary to be able to roll over the lump-sum death benefit into an IRA. For example, the beneficiary may be working and more in need of a deferment to retirement than in need of an immediate payment. An opportunity to defer receipt may be just as important to a beneficiary as to an employee.

Distribution restrictions on rollovers to IRA's from qualified plans

The enclosed memorandum was submitted to the IRS in January, 1976 in connection with the Proposed IRA Regulations that were released by the IRS in February but, to date, have not been issued in final form.

The memorandum discusses the question of whether a lump-sum distribution from a qualified plan can be transferred to an IRA account or an IRA annuity after a terminating employee has attained age 70½. It is concluded that the Code would permit such a rollover, providing the lump-sum distribution is transferred to an IRA annuity under Code Section 408(b) and providing the annuity contract provides for an immediate distribution in the form of annuity payments (as a life annuity or as an annuity certain). It is also concluded that the Code would not permit a lump-sum distribution to be transferred to an IRA ACCOUNT after attainment of age 70½.

It is therefore suggested that the Proposed Regulations be amended as described in the memorandum. If it is concluded that the Proposed Regulations cannot be changed, then it is suggested that an appropriate change be made in Code Section 408(b).

DISTRIBUTION RESTRICTIONS ON ROLLOVERS FROM QUALIFIED PLANS

Lump-sum distribution

Under Code Section 402(a)(5) and 403(a)(4) permission is given to an employee terminating participation in a qualified plan to rollover a lump-sum distribution into an Individual Retirement Account (IRA account) or an Individual Retirement Annuity (IRA annuity).

Under either of these Code Sections, the lump-sum distribution must come within the definition contained in Code Section 402(e)(4)(A), which means that it must become payable (i) on account of the employee's death, (ii) after the employee attains age 59½, (iii) on account of the employee terminating employment, except in the case of a self-employed person, or (iv) after the employee has become disabled.

It is to be noted that Code Sections 402(a)(5) and 403(a)(4)(A) both provide that the lump-sum distribution must be paid to the employee. This means that a lump-sum death benefit referred to in Item (i) above cannot be rolled over into an IRA account or an IRA annuity.

However, it should be noted that neither Section 402(a)(5) nor 403(a)(4) contain a proviso to the effect that the lump-sum distribution must be received before the close of the taxable year in which the employee attains age 70½

Moreover, it should be noted that Section 402(a)(4)(A) does not contain a proviso to the effect that the lump-sum distribution must be received before age 70½. Item (ii) does state that the lump sum must be received after age 59½, but does not state that it must be received before age 70½.

Thus, insofar as the lump-sum distribution is concerned, it may be received before the close of the taxable year in which the employee attains age 70½.

Transfer to an IRA

A rollover contribution received under Section 402(a)(5) or Section 403(a)(4) may be transferred under the provision of Section 402(a)(5)(B)(i) or Section 403(a)(4)(B)(i) into an IRA account or an IRA annuity. Neither of these latter Sections states that the transfer must be made before the close of the taxable year in which the individual attains age 70½.

Deduction restrictions

Code Section 219(b)(3) states that no deduction is allowed if a contribution is made in a taxable year in which an individual attains age 70½ or thereafter. However, Section 219(b)(4) states that no deduction is allowed in respect to a rollover contribution under Section 402(a)(5) or Section 403(a)(4), so the loss of deduction under Section 219(b)(3).

It is to be noted that neither Section 219(b)(3) nor Section 219(b)(4) prohibits the making of a rollover contribution after age 70½. The Sections merely say that no deduction is permissible.

Distribution from an IRA account

Under section 408(a)(6), the entire interest of an individual under an IRA account must be distributed (a) not later than the close of his taxable year in which he attains age 70½, or (b) commencing not later than the close of such taxable year, as (A) a life annuity for him or as a joint and survivor annuity for him and his spouse, or (B) an annuity certain for a period not longer than his life expectancy or the life expectancy of him and his spouse.

Thus, in the case of an IRA account, distribution must be made or commence to be made before the close of the taxable year in which the individual attains age 70½. Therefore, because of this restriction, it would not be possible to transfer into an IRA account, a lump-sum distribution received after the close of such taxable year.

Distribution from an IRA annuity

Under Section 408(b)(3), the entire interest of an individual under an IRA annuity must be distributed (a) not later than the close of his taxable year in which he attains age 70½, or (b) as, (A) a life annuity for him or as a joint and survivor annuity for him and his spouse, or (B) an annuity certain for a period not longer than his life expectancy or the life expectancy of him and his spouse.

Comparing (b) in respect to a distribution from an IRA annuity with (b) in respect to a distribution from an IRA account, it is to be noted that the restriction that the annuity payment must commence not later than the close of the taxable year in which the individual attains age 70½ has been omitted from Section 408(b)(3).

Therefore, if a lump-sum distribution is received under Section 402(a)(5) or Section 403(a)(4) after the close of the taxable year in which the individual attains age 70½, he may transfer such distribution into an IRA annuity, providing the distribution from the IRA annuity is in the form described in (A) or (B) under (b) above, even though such distribution commences after the attainment of age 70½.

Proposed regulations

Proposed Regulation Section 1.408–3(b)(3) in respect to an IRA annuity simply states that distribution must be made as provided in Section 1.408–2(b)(6), which Section is in respect to an IRA account and require that distribution be made prior to attainment of age 70½ or commence to be made before such age.

In view of the conclusion referred to above, it is suggested that Proposed Regulation Section 1.408–3(b)(3) in respect to an IRA annuity should not refer to Section 1.408–2(b)(6) and that it should permit an annuity payout to commence after age 70½, providing the IRA annuity has been purchased by a lump-sum distribution under Code Section 402(a)(5) or 403(a)(4) and providing the payout commences not more than 1 month after the IRA annuity contract is purchased.

Starting age	Accumulated amount at age 65	Annual life annuity commencing a age 65 (with no minimum guaranteed period)	
		Male	Female
40	$87,234	$9,360	$8,341
45	58,490	6,270	5,588
50	37,010	3,962	3,530
55	20,958	2,236	1,993
60	8,963	947	844

At ages beyond 45, it is obvious from the above table that contributions of $1,500 per year are going to produce inadequate retirement pensions for anyone who can afford to set aside $1,500 per year.

Therefore, it is suggested that the limits of 15 percent/$1,500 for IRA's and LERA's are too low and that they should indeed be raised to 15 percent/$2,000 if not to some larger limit. For this purpose Code Section 219(b)(1) and proposed Section 220(b)(1)(A) would need to be amended.

A comparison of the 15 percent/$1,500 limit for IRA's with the 15 percent/$7,500 limit for self-employed persons under Keogh plans underlines the need to raise the limit for IRA's. The pension benefits under a Keogh plan could be 500 percent of those under an IRA.

Increased deduction limits

The 15 percent/$1,500 limit for contributions and deductions was first proposed in December, 1971 by President Richard M. Nixon and, subsequently, it was included in Bills S. 3012 and H.R. 12272 submitted to the 92nd Congress. In due course, that limit was included in the Employee Retirement Income Security Act of 1974.

Because the Consumer Price Index has risen appreciably since 1971, Secretary of the Treasury William E. Simon in October, 1975 when testifying before the House Ways and Means Committee on Bill H.R. 10612, proposed that the dollar limit should be raised to $2,000 and that it should be indexed to C.P.I.

Most IRA's are started by individuals at ages beyond 45, which means that they normally have fewer than 20 years to accumulate savings for retirement. The following table (which is based on an insurance company's immediate annuity rates) will give an indication of the retirement pension that can be expected to be purchased by an annual contribution of $1,500 accumulated at 6 percent compound interest to retirement at age 65.

Credit for past employment years

Contributions to an IRA at present may be made only prospectively in respect to years following the establishment of the IRA. For an individual of high age, this means he or she has few years in which to accumulate savings for retirement, even though he or she may have many years of past employment during which there was no participation in an IRA or a qualified plan.

It is suggested that provision be included in the Code to permit larger contributions to be made by an individual starting an IRA at a higher age in order to compensate for the years in which no contributions were made. For example, the percentage of 15 percent could gradually be raised to, say, 25 percent for ages higher than 45, for an individual starting an IRA over age 45. And, similarly, the dollar limit could gradually be raised over age 45 from $3,000 to, say, $5,000. In each case, the percentage limit and the dollar limit would remain level through to retirement at whatever limits were appropriate to the age at the commencement of the IRA.

The table attached demonstrates the need for permission to make contributions of larger amounts at high ages. The table appended demonstrates the proposal for larger limits at high ages.

COMPARISON OF CONTRIBUTIONS AND BENEFITS

A. *Corporate employer pension plan (401(a) plan)*

Pension Limit. $75,000 per year or 100 percent of highest 3 consecutive years earned income, whichever is lesser.

Assumption. Sufficient annual contribution made each year from starting age to age 65, accumulated at 6 percent compound interest to produce an accumulated amount ($701,050) to purchase a single life annuity from an insurance company of $75,000 per year (based on current rates for a male). No cost-of-living indexing included.

Starting age	Accumulated amount needed at age 65 for pension of $75,000 (male)	Annual contribution needed to produce accumulated amount
30	$701,050	$5,910
40	701,050	12,015
50	701,050	28,350
60	701,050	118,800

B. *Self-employed pension plan (H.R. 10 plan)*

Contribution Limit. $7,500 per year or 15 percent of earned income, whichever is lesser.

Assumptions. $7,500 contributed each and every year from starting age to age 65, accumulated at 6 percent compound interest. Accumulated value at age 65 use to purchase a single life annuity from an insurance company (based on current rates for a male).

Starting age	Accumulated amount at age 65	Annual life annuity starting at age 65 (male)
30	$885,910	$95,130
40	436,170	46,800
50	185,050	19,810
60	44,815	4,735

C. *Individual retirment account (I.R.A.)*

Contribution Limit. $1,500 per year or 20 percent of earned income, whichever is lesser.

Assumptions. $1,500 contributed each and every year from starting age to age 65, accumulated at 6 percent compound interest. Accumulated value at age 65 used to purchase a single life annuity from an insurance company (based on current rates for a male).

Starting age	Accumulated amount at age 65	Annual life annuity starting at age 65 (male)
30	$177,182	$19,026
40	87,234	9,360
50	37,010	3,962
60	8,963	947

Age at establishment of the IRA	Percentage of annual compensation	Annual dollar limit[1]
Up to age 44	15.0	$3,000
45	15.0	3,000
46	15.5	3,100
47	16.0	3,200
48	16.5	3,300
49	17.0	3,400
50	17.5	3,500
51	18.0	3,600
52	18.5	3,700
53	19.0	3,800
54	19.5	3,900
55	20.0	4,000
56	20.5	4,100
57	21.0	4,200
58	21.5	4,300
59	22.0	4,400
60	22.5	4,500
61	23.0	4,600
62	23.5	4,700
63	24.0	4,800
64	24.5	4,900
65	25.0	5,000

[1] This assumes that the limits in proposal 19 are adopted and that the individual is not participating in a qualified plan. If he were participating in a qualified plan, the limits would be reduced as discussed in the main part.

Income earned on an excess contribution

At present, if an excess contribution has earned some investment income while it was in an IRA, this income must be distributed from the IRA. This procedure results in the investment income becoming taxable income and, if it is distributed prior to age 59½, it is subject to a 10 percent penalty tax. This seems to be a lot of fuss and bother for not very much tax. In fact, in many cases the cost of the procedure to all concerned would amount to more than the tax.

It is suggested that a much simpler procedure would be to treat the investment income on the excess contribution in the same manner as that suggested in Proposal (7) for the excess contribution itself. That is to say, to allow the investment income to be applied on account of the next contribution, thereby reducing the amount of the next cash contribution and the deduction available.

This may mean some tax less to the Treasury, but it would certainly mean a savings in expenses for the Treasury and everyone else concerned.

403(b) Plans

In essence, a 403(b) plan (so-called tax sheltered annuity) has always been a type of retirement savings much like an IRA. It is true that the contribution limits are calculated by a different formula. It is also true that technically a 403(b) plan is based on employer contributions. It is also true that the original concept was that a 403(b) plan would be a substitute for a qualified pension plan.

However, in practice, 403(b) contributions are almost always employee contributions developed through a salary reduction agreement. By this means, employees are able to secure deductions for their contributions. Moreover, even if the employer is making contributions to a qualified plan, an employee is still able to make contributions to a 403(b) plan and obtain tax deductions for them, although the deduction limit is reduced because of the employer's contributions to a qualified plan. In practice, a 403(b) plan is really a type of IRA, subject to different limits and different requirements.

Because a 403(b) plan is like an IRA, I suggest that IRA's be not extended to active participants in 403(b) plans.

Excess accumulations at age 70½

The law provides that if the accumulation on hand at age 70½ is not distributed sufficiently quickly, a tax of 50 percent of the excess accumulation is levied. It is suggested that this is much too severe a penalty and that the tax rate should be reduced to, say, 10 percent or 20 percent. See Code Section 4974(a).

Moreover, the method specified in the proposed regulations for calculating the amount of the excess accumulation is far too complicated. It is beyond the ability of an average taxpayer to understand. It is suggested that a much simpler procedure could be developed for inclusion in the regulations. See Code Section 4974(b) and Proposed Regulation Section 1.408-2(b)(6)(v).

Joint and survivor settlement

In the case of an IRA plan established and maintained by an employer under Code Section 408(c), such plan apparently is considered to be an "employee pension benefit plan" under ERISA Section 3(2). As such, ERISA Section 205 becomes applicable to the IRA plan, which means that the basic method of settlement at retirement must be a joint and survivor annuity.

Because an IRA plan must provide for the range of settlement options spelled out in Code Section 408(a)(6), it is confusing and unnecessary to require a joint and survivor annuity to be the basic settlement. Therefore, it is suggested that ERISA Section 205 be amended to exclude an IRA plan.

Because Code Section 401(a) applies to only a qualified pension plan and because an IRA plan is not a qualified plan. Code Section 401(a)(11) is not applicable to an IRA plan. Code Section 401(a)(11), therefore, does not need to be amended.

Mandatory lump-sum distribution

In order to fully develop the portability concept, it is suggested that the Code be amended to require every qualified plan to provide the following two provisions:

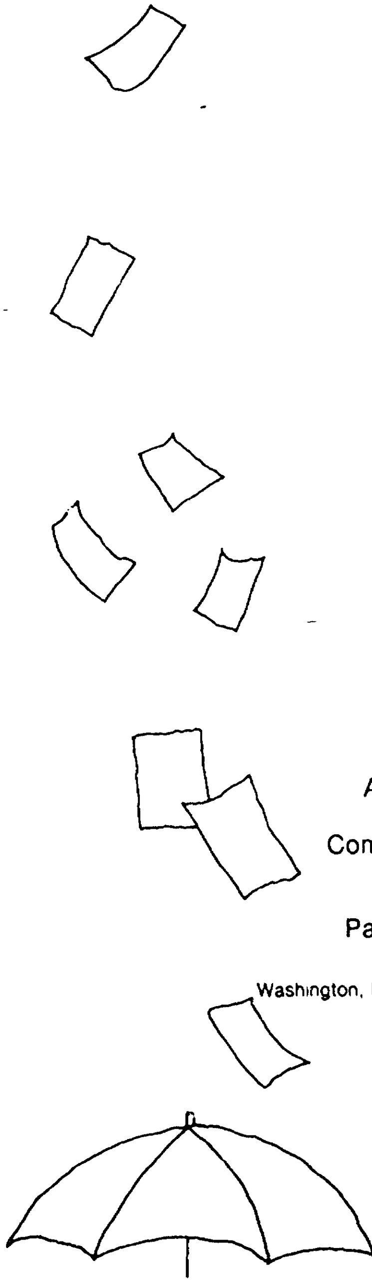
(a) In the event of termination of employment or termination of a plan, a qualified plan must permit an employee to elect to receive a lump-sum distribution, which he or she could roll over into an IRA or another qualified plan.

(b) A qualified plan must provide for an employee becoming a participant to have the option of rolling over in that plan a lump-sum distribution received from another qualified plan or the value in a rollover IRA that has originated from another qualified plan.

If the Code is amended as suggested to permit the appending of a LERA provision into a qualified plan, such provision could be used to receive the lump-sum distribution or the value in a rollover IRA as referred to in (b) above.

APPENDIX C

A Report of the Commission on Federal Paperwork—The Employee Retirement Income Security Act



A Report of the Commission on Federal Paperwork

The Employee Retirement Income Security Act

December 3, 1976

Washington, D.C. 20582

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COMMISSION ON FEDERAL PAPERWORK
1111 TWENTIETH STREET, N.W.
WASHINGTON, D. C. 20582

The President of the United States
The Speaker of the House
President of the Senate

Dear Sir:

In behalf of the Commission on Federal Paperwork, pursuant to Public Law 93-556, I am submitting a report with recommendations concerning the Employee Retirement Income Security Act. It is among the several interim reports the Commission will submit before completing its final report in October 1977.

Since its enactment in 1974, the Employee Retirement Income Security Act has become the subject of considerable criticism because of the complex and duplicative paperwork burdens it imposes on employers. The statute relies fundamentally on disclosure of private pension plan provisions, funding, and management as evidence of adherence to the minimum standards it mandates. Timely submittal of detailed reports is thus an essential element of effective administration of the law.

The Commission's objective has been to propose solutions to paperwork problems of private pension plans that will reduce the complexity and cost of compliance with the Employee Retirement Income Security Act. We estimate that acceptance of the recommendations in this report can result in savings to business of more than $357 million when first implemented and of more than $283 million annually thereafter. The Government could lower its costs by almost $50 million initially and save about $5 million per year after instituting the improvements recommended by the Commission in this report.

Respectfully yours,

Frank Horton

Frank Horton, M. C.
Chairman

Contents

I.

Introduction

On September 2, 1974, the Employee Retirement Income Security Act of 1974 (ERISA)[1] became law. ERISA was a response by Congress to an increase in the number of persons counting on private pension benefits; the growth of pension plan assets as a factor in the economy; and the disappointment of plan participants and beneficiaries by the failure of underfunded plans to provide benefits as promised.

This report reviews and makes recommendations to eliminate excessive paperwork requirements in this very necessary and laudable program. Recommendations are made to:

- eliminate unnecessary and duplicative reporting and recordkeeping requirements;
- make more understandable the information provided to plan participants; and
- simplify the complex and confusing procedures of the program.

It is the belief of the Commission on Federal Paperwork that the recommendations contained in this report will strengthen ERISA by:

- making the program easier to understand and more effective for plan participants and administrators;
- removing unnecessary administrative costs borne by plans and their participants, with first-year cost savings for the recommendations in this report totaling $74.5 million and about $283.2 million annually thereafter; and
- making the program requirements clearer and more manageable to remove 'paperwork exercises' from the effective regulation of pension plans.

Growth of Pension Plans

The private pension industry has experienced rapid growth and ensuing complexity in recent years due to several developments. Employers increasingly have accepted responsibility for the physical and economic well-being of their retired employees. The tax structure offered incentive by permitting employers to deduct contributions and thus reduce significantly the real cost of pension plans. Government-administered retirement income systems, such as Social Security and Railroad Retire-

[1]Public Law 93-406, approved September 2, 1974, 88 Stat. 829.

ment, had been installed in the 1930's, but these were limited in coverage and benefits, and private pension plans were seen by many as a needed supplement.[2]

Two special factors stimulated the growth of private pension plans during and after World War II. Wartime wage freezes generated interest in deferred compensation; fringe benefits could be granted in lieu of wage increases. Then a Federal court ruled in 1947 that private pension plans were a proper subject for collective bargaining under the National Labor Relations Act.[3]

In 1940, there were less than 2,000 private pension plans in existence. At the end of 1946 there were, in round numbers, 9,400 plans which had been qualified by the Internal Revenue Service (IRS) for tax deduction purposes, covering 3.6 million employees. By the end of 1973, there were 369,000 qualified plans covering an estimated 30 million employees.[4] If the number of beneficiaries is added to the number of plan participants, the total of potential recipients in all active plans probably exceeds 100 million.

Total plan assets have grown commensurately. According to one estimate, the book value of assets of all private, non-insured pension funds increased from $33 billion in

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[2]See House Report 93-533, October 2, 1973 [to accompany H.R. 2]; House Report 87-898, August 18, 1961 [to accompany H.R. 8723].

[3]*Inland Steel Co.* v. *National Labor Relations Board,* 170 F. 2d 247 (1949), *certiorari* denied, 336 U.S. 960 (1949). The decision, by the U.S. Court of Appeals for the 7th Circuit, was to the effect that pension benefits were included in the terms "wages" and/or "other conditions of employment," which under the law were subject to collective bargaining.

[4]The IRS data cover pension, annuity, profit-sharing and stock bonus plans that are determined to be qualified for tax-deduction purposes. They do not necessarily reflect the total number of plans in existence, since many plans are not the subject of advance determination, and other plans are not subject to tax benefits. The Congressional Research Service, in 1974, cited a Department of Labor estimate that there were 1,800,000 private benefit plans, if welfare plans (relating to accidents, sickness, etc.) and pension plans for the self-employed (Keogh plans) were included. Excluding those two categories, the number of pension plans was estimated at 350,000. The number of employee participants in plans covered by ERISA was estimated at 35 million. "Private Pension Plan Reform: A Summary of the Employee Retirement Income Security Act of 1974 (Public Law 93-406)," Congressional Research Service, Library of Congress, September 19, 1974.

1960 to $118 billion in 1972.[5] A relatively few large corporations account for the bulk of assets and covered employees. In the 1960-1972 period, total assets of the 100 retirement plans reporting the largest assets increased from $18 billion to $53 billion. The 100 largest plans thus accounted for 45 percent of the assets of all private, non-insured pension plans in 1972.[6]

Although the figures vary somewhat, depending on source, definition of plans included, and time of estimate, the magnitudes suggest the scope of the regulatory problem.[7] The paperwork burdens associated with ERISA derive from the complexities of the legislation, the large number and diversity of plans, the detailed and exacting reporting and recordkeeping requirements, and the divided responsibilities for Government administration. As is usually the case, the burden falls most heavily on the small companies. Although there is some leeway in the law for easing paperwork burdens, for the most part plans of every size and description must comply with the recordkeeping, reporting, disclosure, and other requirements.

Types of Benefit Plans

Benefit plans covered by ERISA fall into two broad categories: welfare and pension. Welfare plans, sometimes termed welfare benefit plans, confer such benefits as medical, surgical or hospital care; benefits relating to sickness, accidents, disability, death, or unemployment; vacations, apprenticeship or other training programs; day care centers; scholarship funds; and prepaid legal services. Pension plans, also called employee pension benefit plans, provide retirement income to employees or make other arrangements for deferred income related to employment.

ERISA identifies three basic types of pension plans:

1. *Defined contribution plan,* also called individual account plan, in which each participant has an individual account, and the benefits are based solely on what is contributed to that account. This category includes what are termed profit-sharing plans and money purchase plans. The profit-sharing plans hinge contributions and benefits on current and accumulated profits of the employer. In money purchase plans, the amount of contribution is determined in advance by a formula, such as a stated percentage of the participant's salary.

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[5]"Survey of the 100 Largest Retirement Plans, 1960-1972," U.S. Department of Labor, Washington, D.C., August 1974.

[6]See footnote 5.

[7]House Report 93-533, October 2, 1973 [to accompany H.R. 2].

2. *Defined benefit plan*, generally, is a plan with tax-deductible contributions that is not in the first category. Funding here, as in the case of a money purchase plan, is not dependent upon employer profits for the current or prior year. The employee, at retirement, receives a predetermined income which must be calculated by an actuary, as prescribed by law.

3. *Excess benefit plan* is a plan maintained by employers solely for the purpose of providing for certain employees benefits that exceed limitations in the tax code on contributions and benefits and, to that extent, are not tax-deductible.

ERISA also refers to "multi-employer plans," in which contributions are made by more than one employer and are maintained pursuant to collective bargaining agreements with employee organizations. Under such plans, benefits are payable to a participant even if his particular employer goes out of business or otherwise ceases to make contributions.

In the case of welfare plans, the Secretary of Labor has somewhat more authority to ease paperwork burdens than in the case of pension plans. The Secretary may, by regulation, exempt any welfare plan from all or part of the reporting and disclosure requirements of Title I of ERISA; or the Secretary may provide for simplified reporting and disclosure upon finding that such requirements are inappropriate as applied to welfare plans. The Secretary has elected to exempt welfare benefit plans covering fewer than 100 participants, and which meet certain other requirements, from designated reporting and disclosure provisions.[8]

Comparable exemptions are not permitted for pension plans; the Secretary is allowed merely to prescribe simplification of annual reports, and only when plans cover less than 100 participants. Another provision allows him to waive or modify requirements for detailed actuarial data in annual reports if the interests of participants and beneficiaries will not be harmed and if the information needs of both the participants and the Government are not justified by the expense of compliance.[9]

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[8] Code of Federal Regulations, Vol. 29, Chap. XXV, Subchapter C, p. 369.

4 [9] ERISA, section 104(a)(2)(A).

Divided Administration

The division of Government responsibilities for administration of ERISA also contributes to the paperwork burden. The Department of Labor (DOL), the Department of the Treasury, and a new Government corporation all are involved. In the DOL, primary responsibility for administering and enforcing ERISA provisions has been delegated to the Assistant Secretary for Labor-Management Relations, who heads the Labor-Management Services Administration, a component of which is the Office of Pension and Welfare Benefit Programs.[10] In the Department of the Treasury, the IRS qualifies pension plans for tax purposes and carries out other prescribed functions, working through the Office of Assistant Commissioner for Employee Plans and Exempt Organizations.[11]

A separate unit, the Pension Benefit Guaranty Corporation (PBGC), was created by ERISA to insure plan participants and beneficiaries against loss of benefits due to complete or partial termination of benefit plans. This Government corporation, though housed within the DOL, is managed by a board of directors consisting of the Secretaries of Commerce, Treasury, and Labor, with the latter serving as Chairman. Assisting the PBGC is a 7-member advisory committee appointed by the President from among persons recommended by the board of directors.[12]

The responsibilities of the Secretary of the Treasury and the Secretary of Labor come together in such regulatory areas as participation, vesting, and funding. Thus, substantially identical requirements for minimum standards that pension plans must satisfy are prescribed in separate titles of ERISA for administration by both departments.[13]

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[10]The delegation of authority is set out in Secretary of Labor Order 27-74, 39 *Fed. Reg.* 43136 (November 1, 1974). The administering office previously was called Office of Employee Benefits Security. The ERISA regulations of the Department of Labor are carried in Code of Federal Regulations, Vol. 29, Chapter XXV.

[11]Temporary regulations on IRS procedure and administration regarding ERISA are carried in Code of Federal Regulations, Vol. 26, Chapter I, Part 420. See 39 *Fed. Reg.* 34052 (September 23, 1974).

[12]ERISA, section 4002.

[13]ERISA, Part 2, of Subtitle B of Title I; Internal Revenue Code of 1954, Subchapter D of Chapter 1 of Subtitle A.

The IRS would have to be involved, to a certain extent, under any administrative arrangement, since it has an unavoidable duty to see that tax deductions for benefit plans are in full compliance with the complex Internal Revenue Code provisions. It has been qualifying pension plans ever since tax deductions for such purposes were permitted by law many years ago.[14] However, ERISA makes the IRS a full-fledged partner with the DOL in the regulatory scheme.

The divided administration of ERISA probably reflects political rather than administrative necessity. Committees of jurisdiction in the Congress in tax and labor/welfare areas were active participants in the development of the legislation, and the interests of both sides were accommodated. The Secretaries of Labor and Treasury were directed by the statute to work cooperatively and to avoid unnecessary duplication.[15]

Reporting and Disclosure Requirements

To convey a sense of the elaborate reporting and disclosure requirements in ERISA, their main provisions in Titles I, II, and IV are summarized. The reporting burdens fall primarily on employers, or plan administrators in their behalf. Plan administrators must report and disclose to three Government agencies: the DOL, the IRS, and the PBGC; and to two private groups: employees and their beneficiaries. In some cases, reports are mandated directly by law; in others, they are made if individually requested or required by regulation.

To each plan participant and beneficiary receiving benefits, plan administrators must furnish the following information:

- Summary plan descriptions, written so as to be understandable to the average participant, within 90 days after becoming a participant or receiving benefits.
- Modifications or changes in plan descriptions not later than 120 days after the end of the plan year.

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[14]For example, the Revenue Act of 1942, 52 Stat. 798, contained detailed provisions on tax benefits for trusts forming part of stock benefits, pension or profit-sharing plans of employers for the exclusive benefit of employees or their beneficiaries. Previous Revenue Acts, dating back at least to 1928, provided for some benefits in this area, but with much less detail.

[15]ERISA, Title III, section 3004.

- Copies of statements and schedules for a planned fiscal year and such other material as is necessary to summarize fairly the latest annual report, within 210 days after the plan fiscal year.
- Upon written request, a copy of the latest up-dated summary plan description, plan description, annual report, bargaining agreement, trust agreement, contract, or other instrument, for which charges may be levied to cover the cost of furnishing such documents.
- An up-dated summary plan description every fifth year if amendments are made. Otherwise, the submission is to be made every tenth year.
- If the Secretary of Labor so provides by regulation, a statement of the rights of participants and beneficiaries under Title I.
- Upon a request in writing, a statement (not more often than once a year) of total benefits accrued and non-forfeitable (vested); pension benefits, if any, which have accrued; or the earliest date on which benefits will become non-forfeitable.

Additionally, to each plan participant, but not specifically to beneficiaries, plan administrators must furnish the following information.

- A statement setting forth information contained in registration statements which plan administrators must submit under the applicable section of the Internal Revenue Code.
- A report of benefits due, or which may become due, when the participant requests it or terminates service with the employer or has a one-year break in service. The employer is to furnish the necessary information to the plan administrator for the purposes of this report. Not more than one report in one year is required.

To the Secretary of Labor, plan administrators must furnish the following information:

- Annual report for a plan year, within 210 days after close of such year (or such other time as the Secretary may by regulation promulgate to reduce duplicative filings).
- Plan description, on a form prescribed by the Secretary, within 120 days after the plan becomes subject to this part of the statute, and 7

an up-dated plan description, no more frequently than once every five years, as the Secretary may require.
- Copy of the summary plan description when it is furnished to participants and beneficiaries.
- Modifications and changes in summary plan descriptions, within 60 days after their adoption or occurrence.
- Terminal and supplementary reports, as prescribed by regulations of the Secretary, when a plan winds up its affairs. A copy of such report is to be filed with the PBGC. Terminal reports in the case of welfare benefit plans are to be filed if required by the Secretary but are not mandatory in the law.
- Upon request of the Secretary, any documents relating to employee benefit plans, including bargaining agreements, trust agreements, contracts, and other instruments.

Copies of plan descriptions, summary plan descriptions, and annual reports are to be made available for inspection in the DOL's public document room in Washington, D.C.

To the Secretary of the Treasury/IRS, plan administrators must furnish the following information:

- A registration statement containing specified plan information, within such period after the end of a plan year as may be prescribed by regulation.
- Specified changes in plan status, including termination or merger or consolidation with other plans, at such time as may be prescribed by regulation.
- An annual return stating such information as may be prescribed by regulations with respect to qualifications, financial condition, and operations of the plan. In case of merger, or consolidation or transfer of assets of a plan, an actuarial statement of valuation, evidencing compliance with the applicable section of the Internal Revenue Code.

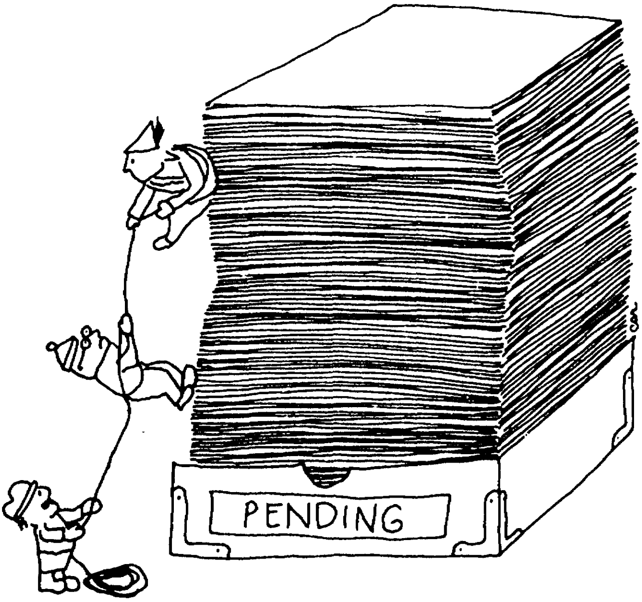
The listing above is not exhaustive; it does not attempt to identify every reporting requirement levied upon taxpayers in connection with tax deductions for, or receipt of benefits from, various types of benefit plans which may qualify under the Internal Revenue Code. Other sections of the report give more detail on these requirements.

To the Pension Benefit Guaranty Corporation, plan
8 administrators must report, within 30 days after occur-

rence, any so-called reportable event. Some nine events are listed in the law; they are concerned with changes which may affect the financial soundness or stability of the plans. The Secretaries or Labor and Treasury also are directed to notify the PBGC when certain of these events occur.

Commission's Preliminary Studies

ERISA paperwork has been the subject of many complaints addressed to the Commission at its public hearings and in correspondence. In January 1976, the Commission held a two-day hearing on ERISA (see Appendix A) and directed its staff to make additional studies of the paperwork problems. Tentative staff recommendations were discussed in a two-day working session, held in August 1976, with representatives of Government and private industry experts, including pension attorneys, certified public accountants, actuaries, and insurance executives. (Appendix B.) Testimony was also received by the Commission in Pittsburgh, Pa., October 14-15, 1976, and in Miami, Fla., on November 19, 1976. (See Appendix C and D.)



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Roundtable discussions at the working session and subsequent recommendations focused on the following problems:

- The multiple filing dates required by the law and regulations. Companies must file in some cases according to tax year and in other cases according to plan year. Some actions must be reported 30, 60, or 120 days before the fact; others must be reported 30, 60, or 120 days after the fact.
- Diverse reporting requirements for single-employer plans and multi-employer plans.
- The amount and kinds of information needed by employees to permit them to evaluate their pension plans.
- Reporting provisions for IRA (Individual Retirement Accounts for individuals not covered by another pension plan) and Keogh plans (retirement plans for the self-employed).
- Means by which companies can more readily provide information required by administering agencies.

The hearings and preliminary studies led the Commission to support several measures for paperwork reduction in the administration of ERISA:

- The concept of model plans for small employers was endorsed, and the IRS was urged to work toward adopting such models. In a news release dated November 5, 1976, Commissioner Alexander announced that model plans would be available within a short time. The model plans are limited to profit-sharing plans and money purchase plans and are for use by employers who do not have any other plans. If model plans were used by all for whom they were designed, a first-year saving of $81 million for business and $50 million for the Government would result and annual savings of $7 million for business and $4 million for the Government thereafter.

- A simplified recordkeeping method for computing hours of service was recommended to the DOL. The hours of service worked are the basis for determining the vesting of benefits for plan participants. The simplified method was based on "elapsed-time," which would allow employers to convert hours of service from weekly or monthly payroll records rather than require hours of service on the basis of
10 days, weeks, months, or shifts worked. It accords

with the sense o the Commission's recommendation. Substantial savings will result, an estimated $240 million per year to employers.

Approach In Report

In this report, the Commission examines additional possibilities for ERISA paperwork reduction and makes recommendations which are considered practicable. The report does not question the basic objectives of the legislation, nor does it attempt to recast the administrative organization provided after years of study, deliberation, and compromise by the Congress. This is a limited-effort study directed primarily to specific changes which can be made rapidly by legislative and administrative action, with sizable reductions in paperwork. The Commission is continuing its study of ERISA, as indicated in the last section of this report.

Glossary

Defined Benefit Plan — an actuarially determined plan based on a certain percentage of an employee's salary.

Defined Contribution Plan — a plan in which employer's contribution is based on a specified formula. Benefits are based on the amount in the fund at the date of retirement or other termination of employment.

ERISA — Employee Retirement Income Security Act of 1974.

IRA — Individual Retirement Account for individuals not covered by another pension plan.

Keogh Plan — retirement plan for the self-employed.

Letter of Determination — issued by IRS stating whether a proposed plan or amendment thereto meets the requirements of the Internal Revenue Code, 1954, as amended, to qualify for favorable tax treatment.

Multi-employer Plan — a plan to which more than one employer contributes and which is pursuant to a collective bargaining agreement.

PBGC — Pension Benefit Guaranty Corporation, set up as a tax-exempt corporation within the Department of Labor to insure private pension plans.

Plan Termination Insurance — program sponsored by PBGC to guarantee payment of pension benefits upon retirement or disability.

Qualified Employee — an employee who has met the age and service requirements necessary to participate in a pension or welfare plan.

Qualified Retirement Plan — one which has met the test of applicable sections of the Internal Revenue Code of 1954, as amended, conferring deductibility upon the employer's contributions to the plan and tax-exempt status for the plan itself.

Single-Employer Plan — pension or welfare plan sponsored solely by one employer.

Vested Benefit — a nonforfeitable benefit which has accrued to a participant.

WPPDA — Welfare and Pension Plans Disclosure Act, passed in 1958.

II.

Legislative History of ERISA

Except for tax-deductibility provisions, the first Federal legislation dealing with private pensions required informing employees of benefits for which they might be eligible under the plan provisions.[1] The Revenue Act of 1942 permitted employers to deduct payments or contributions toward a qualified retirement plan on behalf of their employees, but the act excluded payments to plans providing for the retirement of individual proprietors and partners. In 1956, Representative Eugene J. Keogh of New York introduced several bills designed to end this discriminatory tax treatment, and in 1962, a law was enacted which granted relief to the self-employed.[2]

In 1958, Congress passed the Welfare and Pension Plans Disclosure Act (WPPDA),[3] which required pension plan administrators to maintain the financial integrity of pension funds and to submit reports that were made public. However, the law did not serve to prevent malfeasance on the part of employers and administrators, despite subsequent amendments.

ERISA can be traced[4] to the 1965 report of a committee appointed by President Lyndon B. Johnson, which recommended that Federal standards be imposed on the private pension system. The proposed act was due, in part, to the continuous flow of complaints from participants regarding specific private pension plans — severe age and service requirements before eligibility for a pension, inadequate funding by employers, and termination of plans without funds. The legislation was intended to assure pensions to qualified employees and prevent the diversion of pension funds for private purposes by the employer or union involved.

The Presidential Committee report[5] focused attention on some of the substantive private pension plan issues and

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[1]Internal Revenue Code of 1954, Reg. 1.401-1(a)(2).
[2]Self-Employed Individual Tax Retirement Act of 1962, Public Law 87-792, approved October 10, 1962.
[3]29 U.S.C., Sec. 141, *et. seq.*
[4]*Monthly Labor Review*, November, 1974; (Reproduced by the Library of Congress, Congressional Research Service, October 31, 1975).
[5]Public Policy and Private Pension Programs, A Report to the President on Private Employee Retirement Plans by President's Committee on Corporate Pension Funds and Other Private Retirement and Welfare Programs, January, 1965.

recommended specific Federal standards for vesting and funding. In 1967, a comprehensive reform bill was introduced in the Senate which called for a strengthening of the WPPDA by establishing fiduciary, vesting, and funding standards as well as a system of pension plan termination insurance. The result was an omnibus, lengthy bill. The following year, the executive branch submitted specific recommendations regarding vesting, funding, and termination insurance. Hearings were held in 1968, but it was not until 1972 that any legislative committee in either House favorably reported a bill.

The bill which eventually became ERISA on September 2, 1974, was the product of several others. The principal concepts were a combination of the original bill S. 3598, introduced in the Senate on May 11, 1972 by Senators Harrison A. Williams, Jr. and Jacob K. Javits; the Comprehensive Private Pension Security Act, S. 1179, introduced on March 13, 1973, by Senator Lloyd Bentsen; and H.R. 1269, introduced in the House in the same year by Representative John H. Dent. After revision, these bills became the basis of ERISA: on the Senate side, as S.4[6] of the Labor and Public Welfare Committee, and S.1179[7] of the Finance Committee; and on the House side, H.R. 2[8] of the Education and Labor Committee, and H.R. 12481[9] of the Ways and Means Committee.

Added impetus for the legislation came on March 12, 1970, when the Senate appropriated funds for an investigation of the United Mine Workers Pension Fund. The resolution also mandated "a general study of pension and welfare funds with special emphasis on the need for protection of employees covered" (S. Res. 360, 91 Cong. 2d sess.). The study was to be conducted by the Senate Subcommittee on Labor.

On the House side, a pension task force established during the 92d Congress under the direction of Chairman John H. Dent and Ranking Minority Member John N. Erlenborn was assigned a similar function. The House

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[6]April 18, 1973 (Senate Report No. 93-127).
[7]August 21, 1973 (Senate Report No. 93-383).
[8]September 25, 1973 (House Report No. 93-533); on Feburary 19, 1974 (H.R. 12906 — Title I).
[9]February 5, 1974 House Report No. 93-779); on February 21, 1974 (H.R. 12855 — Title II).

focused its activity on expanded coverage of private pension plans and increased benefits.

With mandates by both Houses, Congress began a comprehensive investigation and study of all aspects of the system. The broad purpose was to determine the effectiveness of the system in assisting workers to plan and provide for retirement of indeterminate length and uncertain needs with some form of economic security where pensions had been promised by employers. Simultaneous studies were conducted by the White House and executive branch agencies.

Congress was seeking answers to the following questions:[10]

- Were there adequate vesting provisions in plans for employees who had not reached eligibility for normal retirement benefits but had terminated employment?
- Were pension funds sufficiently funded by employers to meet the plan's liabilities?
- Was insurance necessary to protect workers in the event of plan termination without sufficient assets?
- Were additional fiduciary safeguards necessary to protect the security of plan assets?
- Was there need of a system of reporting to a Federal agency to permit compliance monitoring of the law?
- Was there need to improve reports and disclosures to participants to assure understanding of their rights and obligations under the plan?
- Was there adequate regulatory jurisdiction by the Federal government to oversee the administration and operation of private pension plans?

Congress did obtain answers to these questions over a three-year period by methodical and analytical investigations and studies. To define problems and assess appropriate legislative corrections, Congress utilized three avenues. These were:

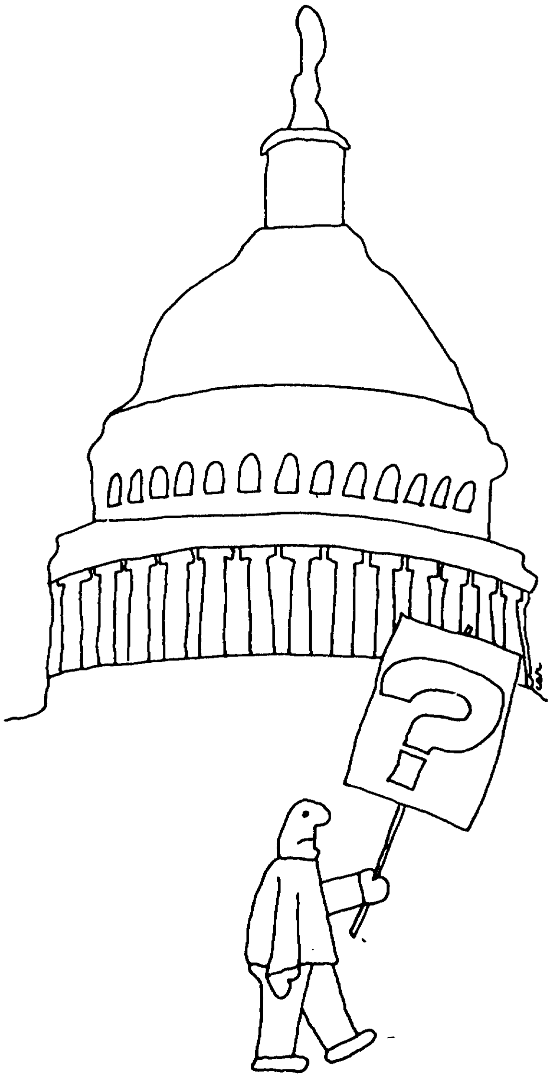
1. Statistical analyses of detailed data requested of and furnished by private pension plans,

2. Public hearings and exposure of individual and group cases illustrating problem areas,

3. Consideration of views from labor unions, management, the banking and insurance industries, accountants and actuaries, U.S. Chamber of Commerce, National Association of Manufacturers, and various governmental agencies.

[10]House Report No. 93-807, February 21, 1974

During the legislative process, principally in the early investigatory and formative stages, there were two competing schools of thought as to the nature and extent of remedial legislation necessary, if any. One advocated stringent government controls. The other, equally adamant, resisted any regulatory controls or expanded



disclosure of plan administrations and operations. Some voices of opposition predicted plan inflexibility, stunted development, and even a collapse of the private pension industry. As yet these fears have been unrealized.

It was apparent earlier that neither school of thought represented a realistic view. In the view of Congress, there was little doubt that private pensions required fuller disclosure to employees. This would not be incompatible with desired flexibility and projected cost increases which were indispensable. Congress deemed it essential that the administrators exercise sound judgment and flexibility to implement the legislative findings and final enactment. To do otherwise would serve only to frustrate and negate Congressional intent and impose undue hardship upon the persons or entities financing or administering the plan.[11]

The principal mechanism designed by Congress to assure efficient and effective enforcement was the submission of reports. The remedial thrust of ERISA is to prescribe minimum standards for pension plans. Compliance is determined by agency review of reports to the DOL and the IRS. ERISA mandates pension plans to comply with:

- Minimum vesting provisions to preclude denial or loss of benefits where long years of employment are terminated prior to eligibility for benefits,
- Accumulation of assets at prescribed rates to meet obligations due workers under plan terms,
- Plan termination insurance to cover unfunded, vested benefits,
- Prescribed uniform standards and responsibilities imposed upon plan fiduciaries,
- Disclosure of plan terms and detailed descriptions of trust agreements indicating participant rights and liabilities and plan assets, revenues and disbursements, and
- Improved and expanded disclosure and communication to participants for comprehension of individual rights and obligations under a plan.

The law demands disclosure of pension fund financial transactions and of the identity and conduct of administrators, trustees, and fiduciaries. A high degree of trust, responsibility and accountability is imposed by ERISA upon these individuals or institutions responsible for the investment and disbursement of the hundreds of billions of dollars in plan assets.

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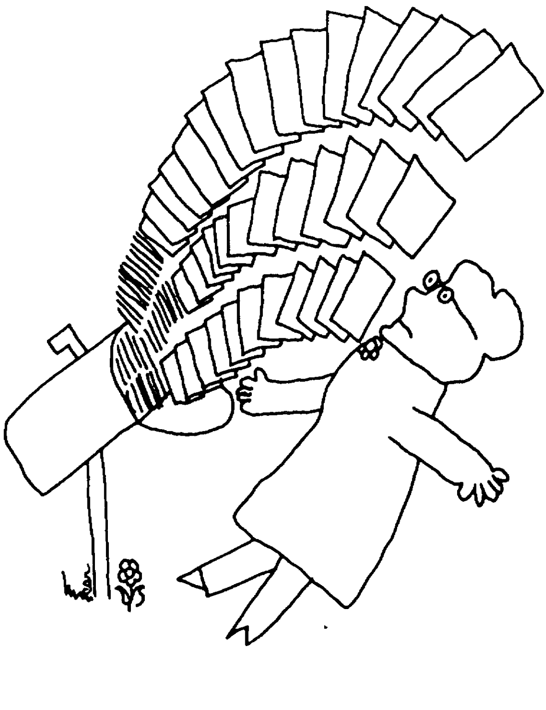
[11]Statement before Commission on Federal Paperwork Hearing, Washington, D.C., January 29, 1976, Mario T. Noto, Attorney.



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III.

Department of Labor Reporting Requirements

Under the Welfare and Pension Plans Disclosure Act of 1958, prior to ERISA, administrators of certain employee benefit plans were required to file reports with the Department of Labor. The act was applicable to administrators of benefit plans affecting commerce except for government plans; those of certain private, nonprofit organizations; plans with fewer than 26 participants; and plans providing workers' compensation benefits. All plans covered by the act filed plan description reports (Form D-1), and plans with 100 or more participants filed annual financial reports (Form D-2). Amendments and changes to plans were reported on Form D-1A. Plans administered by foreign corporations that covered employees working in the United States also were required to file these reports.

The plan description report (Form D-1) contained information on such plan characteristics as type of administration, type of funding, fiscal year basis, type of employee covered, and plan provisions. The annual financial report (Form D-2) included a statement of assets and liabilities by type as of the end of the plan's fiscal, policy or contract year; receipts and disbursements made during the year; number of plan participants; party-in-interest holdings and transactions; and other financial information.

The Form D-2 did not require certification by a public accountant, and the act did not specify or define the qualifications of those preparing any actuarial data that might have been reported. Reports under the act were available for public inspection in Washington, and copies were provided upon request at a reasonable charge.

Under ERISA, administrators of employee benefit plans must provide to each plan participant and beneficiary the following information automatically, without receiving any special request:

- A summary description of the plan, sufficiently accurate and comprehensive to inform the participant of his rights and obligations, written to be understandable by the average participant, and presented in a format satisfactory to the Secretary of Labor.
- Timely notice of any material amendments to the plan.
- A revised plan description, in the event of material amendments, every five years. If there are no such

amendments, the summary description of the plan must be re-issued every 10 years.

- Information from the annual report showing assets and liabilities of the plan, receipts and disbursements from the plan during the year, and other information needed to summarize the financial experience of the plan. The Secretary of Labor prescribes the form of this report, which must be provided to DOL within 120 days after the end of the plan's fiscal year.
- A statement of accrued and vested benefits, upon request but not more often than once a year.
- Information about their vested benefits to participants who terminate their employment during the year.

The Secretary is authorized to require that plan administrators also provide each participant and beneficiary with a statement of his rights under Title I of ERISA. The plan administrator must permit inspection of the latest annual report of the plan and provide copies for plan participants and beneficiaries upon their written request and payment of a reasonable charge. The Secretary may prescribe special disclosure requirements for multi-employer plans, and welfare benefit plans may be exempted from any of the reporting and disclosure requirements of the law.

Unless they are exempted by the Secretary, employee benefit plan administrators must file with the Secretary Form EBS-1 (the plan description), as well as the same summary plan descriptions and notice of amendments that are provided to participants and beneficiaries. Administrators must also file annual financial reports (Series 5500) containing:

- A financial statement prepared by an independent qualified public accountant. Master reports may be filed by banks, insurance companies, and similar institutions.
- Information on the number of employees covered by the plan; the name and address of each fiduciary; the name of every person compensated by the fund, with certain other information; and the reason for any change in trustee, accountant, insurance carrier, actuary, administrator, investment manager, or custodian.
- An actuarial report in the case of every defined benefit plan required to fund its obligations, except those plans permitted to file simplified reports. The actuary, who must be enrolled to practice before the

Labor and Treasury Departments, must make an actuarial valuation of the plan at least every third year.

- When benefits are purchased from or guaranteed by an insurance carrier, the plan's annual financial report must include a statement from the insurance company for the fiscal year that includes the premium rate or subscription charges; the number of persons covered by each class of benefits; the total amount of premiums received and total claims paid; the dividends or other retroactive rate adjustments; commissions, administrative service, and acquisition costs paid by the carrier; the amounts held to provide benefits after retirement; remainder of premiums; and the names and addresses of brokers, agents, and others to whom commissions or fees were paid, their amounts, purpose, etc.

Terminal and supplementary reports to the Secretary of Labor are mandatory for pension plans. They may be required by the Secretary in the case of terminating welfare benefit plans. The Secretary makes copies of the plan descriptions, summary plan descriptions, and annual reports available for public inspection in Washington. Pension and welfare plans must keep the records on which their reports are based for six years after the reports themselves are filed.

Amendments to Plans

Sixty days after a plan is amended, employers are required to file an additional EBS-1 and to notify their participants of the changes (ERISA section 104(a)(1)(D)). DOL requires that only the portion of the EGS-1 which relates to the change be filled out. However, many employers indicate that, to be sure of satisfying the requirements, they will probably fill in the entire EBS-1. DOL states that these additional, amended EBS-1 forms are simply made part of the record. No specific action is taken.

In view of the fact that employees are notified of changes in their plans, that an annual report containing the same information also must be filed with DOL and IRS, and that there is no specific use for the data in the amended EBS-1, it is believed that a notice of amendment filed with the annual report should replace filing of an EBS-1 sixty days after each amendment. This would not change the requirement to notify participants of plan changes, nor would it have any effect on the employer's decision to seek a determination of tax status from the IRS.

The estimated savings to business would be approximately $12 million annually.

Recommendation No. 1
ERISA Section 104(a)(1)(D) should be amended to require that notices of amendment(s) to pension plans may be filed in connection with the annual report rather than as additional EBS-1's which presently are required within sixty days of a plan change.

Summary Plan Descriptions
Employers must provide a summary plan description to each employee every five years. ERISA section 104(a)(1)(C) requires the administrator of a plan to file with the Secretary of Labor a copy of the summary plan description at the same time that it is furnished to participants and beneficiaries.

The purpose of this provision of the statute was to permit the DOL to review and compare the summaries with the complete plan descriptions to assure their completeness, accuracy, understandability, etc. Such reviews are costly, duplicative, and virtually impossible to perform, considering time and budgetary constraints.

Because DOL receives a copy of the complete plan description and any amendments thereto, it is totally duplicative to forward copies of the five-year summary plan descriptions to the agency. Discussions with DOL personnel indicate that they do not use such filings, and that the costs of storage could be avoided.[1]

It is estimated that DOL storage costs of more than $1 million every five years may be saved for the Government and that the savings to business would be approximately $1.8 million in 1981 and $180,000 annually thereafter.

Recommendation No. 2
ERISA section 104(a)(1)(C) should be amended to eliminate the requirement that a five-year summary plan description be filed with the Department of Labor.

Annual Report to Participants
ERISA section 104(b)(3) requires that a summary of the latest annual report — containing a statement of the value of plan assets and liabilities, receipts and disbursements, and other information summarizing the plan's financial

---

[1]Statement made to Working Session on ERISA (August 30, 1976, Washington, D.C.) and subsequent meetings, by representative, United States Department of Labor.

and actuarial statements — be furnished to each participant. By law, this annual report is to be furnished to the plan's participants within 210 days after the close of the plan year.

In addition to the financial information which must be furnished to the participant of a pension and/or profit-sharing plan, the participant is also entitled, under sections 104 and 105 of ERISA, to the following financial information, upon written request:

- a complete copy of the annual report,
- copies of plan documents,
- statement of the participant's accrued benefits,
- a copy of the latest summary plan description (this is in addition to the mandatory requirement that a summary plan description be furnished participants at stated intervals), and
- a copy of the complete plan description.

As shown on the following pages, the schedule of total assets, liabilities, receipts, and disbursements, as specified by DOL, provides very little information for plan participants about the individual's status in the plan or the adequacy of the plan. (Figure 1.) Furthermore, such financial information is costly to duplicate and distribute.

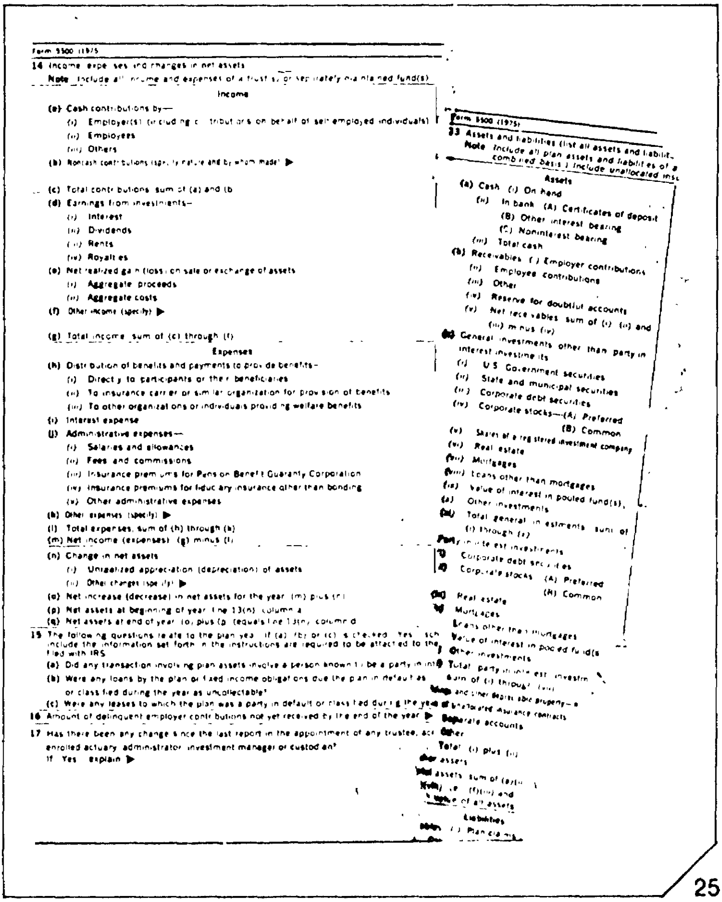
Attached also are examples of simplified formats for reporting information which the plan participants need to know. (Figures 2 and 3.) We believe it is more important for a participant to know the protections afforded him under the law, and for the employer to certify that the protections are provided, than it is for the participant to receive a listing of dollar figures which are usually meaningful only to a pension specialist. Moreover, we believe that the participant should be advised of his status in the plan.

Our recommendation would in no way change the requirement that more detailed information be provided on demand of the plan participant. The participant should at all times have access to detailed information concerning his pension or welfare plan. We suggest that the following is pertinent information required by and useful to plan participants.

Figures 1, 2 and 3

Figure 1 illustrates the complex information that is forwarded to participants at present. Figures 2 and 3 present simpler formats for providing participants with information that meets the ERISA reporting requirements.

Figure 1



Form 5500 (1975)

14 Income, expenses and changes in net assets

Note: Include all income and expenses of a trust(s) or separately maintained fund(s)

Income

(a) Cash contributions by—
(i) Employer(s) (including contributions on behalf of self employed individuals)
(ii) Employees
(iii) Others
(b) Noncash contributions (specify nature and by whom made) ▶
(c) Total contributions, sum of (a) and (b)
(d) Earnings from investments—
(i) Interest
(ii) Dividends
(iii) Rents
(iv) Royalties
(e) Net realized gain (loss) on sale or exchange of assets
(i) Aggregate proceeds
(ii) Aggregate costs
(f) Other income (specify) ▶
(g) Total income, sum of (c) through (f)

Expenses

(h) Distribution of benefits and payments to provide benefits—
(i) Directly to participants or their beneficiaries
(ii) To insurance carrier or similar organization for provision of benefits
(iii) To other organizations or individuals providing welfare benefits
(i) Interest expense
(j) Administrative expenses—
(i) Salaries and allowances
(ii) Fees and commissions
(iii) Insurance premiums for Pension Benefit Guaranty Corporation
(iv) Insurance premiums for fiduciary insurance other than bonding
(v) Other administrative expenses
(k) Other expenses (specify) ▶
(l) Total expenses, sum of (h) through (k)
(m) Net income (expenses), (g) minus (l)
(n) Change in net assets
(i) Unrealized appreciation (depreciation) of assets
(ii) Other changes (specify) ▶
(o) Net increase (decrease) in net assets for the year, (m) plus (n)
(p) Net assets at beginning of year, line 13(n), column A
(q) Net assets at end of year, (o) plus (p) (equals line 13(n), column B)

15 The following questions relate to the plan year. If (a), (b) or (c) is checked "Yes," schedules which include the information set forth in the instructions are required to be attached to the return filed with IRS.
(a) Did any transaction involving plan assets involve a person known to be a party in interest?
(b) Were any loans by the plan or fixed income obligations due the plan in default as of the close of the plan year or classified during the year as uncollectable?
(c) Were any leases to which the plan was a party in default or classified during the year as uncollectable?

16 Amount of delinquent employer contributions not yet received by the end of the year ▶

17 Has there been any change since the last report in the appointment of any trustee, accountant, insurance carrier, enrolled actuary, administrator, investment manager or custodian? If "Yes," explain ▶

91-933 O - 77 - 34

Figure 2

RETIREMENT INCOME STATEMENT

IF YOUR EMPLOYMENT CONTINUES TO AGE 65 AS A PARTICIPANT IN THE RETIREMENT PLAN

IT IS ESTIMATED YOU WILL HAVE RETIREMENT INCOME . . .	MONTHLY
FROM THE RETIREMENT PLAN	$ 198
FROM SOCIAL SECURITY	$ 410
ESTIMATED COMBINED INCOME FOR YOU AT 65	$ 608
ALSO, IT IS ESTIMATED YOUR DEPENDENT SPOUSE WOULD RECEIVE FROM SOCIAL SECURITY ON YOUR ACCOUNT --MAY BE MORE IF YOUR SPOUSE HAS OWN COVERED EARNINGS	$ 150
YOUR 01 01 76 MONTHLY WAGE RATE BEFORE WITHHOLDING	$ 803

AFTER 10 YEARS OF CONTINUOUS SERVICE, YOU ARE FULLY VESTED IN THE PENSION BENEFIT EARNED, PAYABLE AT 65. IF YOU ARE AGE 55 WITH 10 YEARS OF CREDITED SERVICE YOU MAY ELECT EARLY RETIREMENT WITH A REDUCED BENEFIT.

THIS STATEMENT HAS BEEN PREPARED FROM COMPANY RECORDS WHICH SHOW-

BIRTH DATE	10 23 32	6 YRS. 12 MOS.
EMPLOYMENT DATE	1 14 69	CREDITED SERVICE
NORMAL RET. DATE	11 01 97	IN YOUR PLAN AS
BIRTH DATE SPOUSE	3 23 35	OF 1 01 76

- -

YOUR ACTUAL RETIREMENT INCOME WILL DEPEND ON THE PROVISIONS OF THE RETIREMENT PLAN AND THE SOCIAL SECURITY LAW IN EFFECT AT THE TIME YOU RETIRE. THE ESTIMATED PENSION IS BASED ON THE PENSION BENEFIT RATE CURRENTLY IN EFFECT, AND IS FOR YOUR LIFE ONLY WITHOUT PROVISION FOR SURVIVOR INCOME. THIS STATEMENT IS SUBJECT TO CORRECTION FOR ERRORS AND OMISSIONS

IF YOU HAVE QUESTIONS ABOUT THIS STATEMENT, OR FIND ERRORS IN DATA, PLEASE SEE YOUR SUPERVISOR

Figure 3

PREPARED ON 04/09/74

DIVISION 07 288
EMPLOYE 051588

RETIREMENT PLAN #60

PENSION ESTIMATE FOR JOHN D. DOE

DATE OF BIRTH	06 21 26
DATE OF HIRE	07 23 73
PARTICIPATION DATE FOR THIS PLAN	07 23 73
YOUR ANNUAL SALARY	$8,840.00

YOUR NORMAL RETIREMENT PENSION BEGINS WHEN YOU REACH 65. USING THE SALARY ABOVE AS YOUR AVERAGE EARNINGS YOUR INCOME AT NORMAL RETIREMENT IS ESTIMATED AS FOLLOWS-

* FOR SERVICE FROM PARTICIPATION DATE TO NORMAL RETIREMENT - $139.69 PER MO.

* ESTIMATED SOCIAL SECURITY RETIREMENT BENEFITS -
  - -FOR YOU AT AGE 65 $330.00 PER MO.
  - -FOR YOUR DEPENDENT SPOUSE AT AGE 65 $165.00 PER MO.

TOTAL ESTIMATED RETIREMENT INCOME $634.69 PER MO.

* THESE ESTIMATES ARE BASED ONLY ON YOUR CURRENT EARNINGS. WHEN YOU RETIRE YOUR ACTUAL EARNINGS AS WELL AS THE EARNINGS OF YOUR SPOUSE PLUS FUTURE CHANGES TO SOCIAL SECURITY AND TO FEDERAL REGULATIONS WILL DETERMINE YOUR ACTUAL BENEFITS.

For defined contribution plans:

- account balance at the beginning of year;
- contribution on his behalf during the year;
- forfeiture allocated to the participant's account;
- profits/losses allocated to his account;
- account balance at end of year;
- vested benefits; and
- a statement of any loans which may have accrued against his account

For defined benefit plans:

- statement as to current benefits;
- statement as to future benefits; and
- statement by employer that said employer is required by law to fund said benefits and is using acceptable actuarial assumptions.

For both defined contribution and defined benefit plans:

- where and how additional information may be obtained; and
- what assistance is available from the DOL or others.

Recommendation No. 3
Employers should be required to provide simplified statements of accrued benefits and vesting to employees in lieu of the complex financial statements presently required.

IV.

Internal Revenue Service Reporting Requirements

Through a new Office of Assistant Commissioner, Employee Plans and Exempt Organizations, the Internal Revenue Service determines the deductibility of contributions to a private plan, the tax liability of benefits to the retired or terminated plan participant, compliance with the new funding standards created by ERISA, and the tax exemption of the trusts or other funds holding pension plan assets.

Primary administrative responsibility for the participation, vesting, and funding provisions of the new law is also assigned to the IRS. In the usual case, when qualification of a private pension plan is sought, all determination forms, Series 5300, must be filed with the IRS. In addition, the annual reports, Forms 5500, must be filed with IRS as well as with the Department of Labor. The IRS also qualifies for tax deductibility the special retirement income plans for self-employed persons, known as Keogh or H.R. 10 plans, and the Individual Retirement Accounts authorized by ERISA.

Return for Individual Retirement Account
ERISA authorized a new kind of retirement income plan, the Individual Retirement Account (IRA). Those individuals who are not participating in a qualified private or public pension plan are eligible for an IRA. IRS Form 5329 and 5498 must be filed each year by IRA participants with their Federal personal income tax returns. Form 549[illegible] is a transmittal form for the 5498.

According to IRS records, Form 5329 and Form 5498 (Statement of Account for Participants in Individual Retirement Savings Arrangement) are often confused. If an account holder makes a contribution near the end of the calendar year and the financial institution does not post the contribution until the beginning of the new year, there is a discrepancy between Form 5498, which the institution has sent to the IRA holder as a verification of his account, and Form 5329, which the individual files with the IRS. (See Figures 4 and 5.)

Figures 4 and 5

Comparison of Forms 5329 and 5498 shows the similarity of information requested by the Internal Revenue Service.

Figure 4

Form **5329**
Department of the Treasury
Internal Revenue Service

Return for Individual Retirement Savings Arrangement
(Under Sections 408 or 409 of the Internal Revenue Code)
▶ Attach to Form 1040.

1976
Only This Side of Form is Open to Public Inspection

If you have established a retirement savings arrangement you must complete Part I and Part II and attach this form to your individual income tax return, Form 1040. In addition: (1) if you claim a deduction on your Form 1040 for contributions to your retirement savings arrangement, complete Part III; (2) if you have made contributions in excess of your allowable limitation for this year or prior years, complete Part IV; (3) if you are not yet age 59½ when you receive a distribution from your retirement savings arrangement which is not due to a disability, a rollover contribution to another plan or retirement savings arrangement, or the transfer of an amount to a former spouse under a divorce decree, you must complete Part V; (4) if you are 70½ or older on the last day of the year, see instructions to determine if you are required to complete Part VI.

Name

Address (Number and street)

City or town, State and ZIP code

If you are not required to file a Form 1040 check here . . . . ☐

Part I **Individual and Retirement Savings Information**

1 Type of individual retirement savings arrangement:

(a) ☐ Individual retirement account
(b) ☐ Individual retirement annuity
(c) ☐ Individual retirement bonds

2 Were you during any part of the year an active participant in a qualified pension, profit sharing or stock bonus plan, including a qualified Keogh (HR 10) plan, or were you covered under a section 403(b) annuity or custodial account or under a government retirement plan other than the Social Security or Railroad Retirement Acts? (Volunteer firemen and military reservists see specific instructions for line 2) . . . . ☐ Yes ☐ No

If "Yes," you are not allowed a deduction for your 1976 contributions to your individual retirement arrangement.

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than the taxpayer, this declaration is based on all information of which the preparer has any knowledge.

Your signature .... Date ....

Preparer's signature (other than taxpayer) .... Preparer's identification number (see General Instruction B) .... Date ....

Preparer's address and ZIP code ....

Form **5329**

Form 5329 (1976) **This Page Is Not Open to Public Inspection** Page 2

Part II **Attach Copy B of Form 5498 here ▶**

Your Social Security Number . . . . ▶

3 If filed by surviving spouse or beneficiary of an individual who created this retirement savings arrangement check here ▶ ☐
and enter name and social security number of individual for whom the arrangement was established ▶ ....

4 Indicate your age as of the end of the year (If you checked item 3 do not complete this item):
(a) ☐ Under age 59½
(b) ☐ Age 59½ to 70½
(c) ☐ Over age 70½ (if you check item (c) complete Part VI below)

5 (a) If, during the year, you received a distribution of your entire account from a qualified pension, profit-sharing or stock bonus plan, because either (i) you terminated employment or (ii) your employer terminated the plan, and you transferred (rolled over) such distribution to your arrangement, check here . . . . ☐

(b) If you checked (a) did you transfer the entire amount of the distribution (less any amounts you contributed to the qualified plan—see instructions) to your arrangement within 60 days of receipt of such distribution (or 12/31/76 if (a)(ii) applies and you received such distribution prior to 11/2/76)? . . . ☐ Yes ☐ No

(c) If (b) was "Yes," complete lines (i) through (iii) below:

	Month	Day	Year
(i) Date of transfer to arrangement			
(ii) Date distribution was made to you from the plan			

(iii) Name of trustee or insurance company to which the transfer was made (If bonds were purchased state "Bonds") ▶......

(d) (i) If within one taxable year, you received a distribution of your entire account from your employer's qualified pension, profit sharing or stock bonus plan because the plan was terminated by your employer did you:
(A) receive such amount on or after July 4, 1974 but prior to January 1, 1976,
(B) transfer such amount, reduced by the amount of the income tax paid on the distribution on your 1974 or 1975 income tax return, to an arrangement and
(C) file a claim for refund of such tax paid? (Check "Yes" only if (A), (B) and (C) ALL apply.) . . ☐ Yes ☐ No

(ii) If (d)(i) is "Yes," and you have received such refund or credit for such tax paid enter:

	Month	Day	Year
(A) Date refund or credit received			
(B) Date refund or amount of credit was contributed to your retirement savings arrangement . .			

Note: *See Definition C in the instructions concerning rollover contributions.*

	Month	Day	Year
6 If, during the year, you transferred any funds from one retirement savings arrangement to another retirement savings arrangement, enter the date of transfer here			

Caution: *Such a transfer may be a taxable distribution.*

7 If, during the tax year covered by this form, you have entered into a prohibited transaction under section 4975 or borrowed any amount from your retirement savings arrangement or pledged any part of your arrangement as security for a loan, check here . . . . ☐
Note: *See instructions for the tax consequences of such transactions.*

Part III **Computation of Allowable Deduction**
(If you have entered into a prohibited transaction under section 4975, do not complete Part III or Part IV for the retirement savings arrangement with which you entered into such prohibited transaction.)

8 Wages, tips and other compensation from Form 1040 (if a joint return do not include compensation of spouse) (See definition B in the instructions for the meaning of compensation.)		
9 ~~15% of line 8 or $1,500, whichever is lesser (If you are 70½ or over or answered "Yes" to line 2, enter zero)~~		
10 Amount paid by you or on your behalf under all your retirement savings arrangements (do not include any amounts which were considered as "rollover contributions," see lines 5 and 6, or the purchase price of any individual retirement bonds redeemed within 12 months of their date of purchase (see instructions) or life insurance portion of your endowment premium as reported on Form 5498 box 6)		
11 Allowable deduction, lesser of line 9 or line 10 (enter here and on Form 1040, line 40a) . . . . ▶		

Part IV **Tax on Excess Contributions**

12 Tax on excess contributions (see Part IV of the Specific Instructions if Part III, line 10 exceeds line 11). Enter tax from worksheet here and on Form 1040, line 61 . . . . ▶		

Part V **Tax on Premature Distributions**

13 Tax on premature distributions (see Part V of the Specific Instructions if you received a distribution from your retirement savings arrangement before you have attained age 59½). Enter tax from worksheet here and on Form 1040, line 57. . . . . ▶		

Part VI **Tax on Undistributed Retirement Accounts and Annuities**
(See Instructions before completing this Part.)

14 Tax based on current year distribution method, see worksheet in instructions		
15 Tax based on aggregate distribution methods, see worksheet in instructions		
16 Tax due, lesser of line 14 or 15, enter here and on Form 1040, in your total for line 62. On the dotted line to the left of the line 62 entry space write "4974 tax," and show the amount . . . . ▶		

Figure 5

IRS Form 5498

For Official Use Only

Statement of Account For **1975**

Participants In Individual Retirement Accounts or Annuities

Copy A
For Internal Revenue Service Center

Type or print Trustee's or Insurance Company's name, address, ZIP code and Federal identifying number

Participant's social security number	1 Total value beginning of 1975	2 Contributions in 1975	3 Distributions in 1975	4 Earnings in 1975

Statement of Account For **1975**

Participants In Individual Retirement Accounts or Annuities

Copy B
To be filed with Participant's Form 5329

Type or print Trustee's or Insurance Company's name, address, ZIP code and Federal identifying number

Participant's social security number	1 Total value beginning of 1975	2 Contributions in 1975	3 Distributions in 1975	4 Earnings in 1975

Statement of Account For **1975**

Participants In Individual Retirement Accounts or Annuities

Copy C
For Participant's Records

Type or print Trustee's or Insurance Company's name, address, ZIP code, and Federal identifying number

Participant's social security number	1 Total value beginning of 1975	2 Contributions in 1975	3 Distributions in 1975	4 Earnings in 1975
		Regular		

Statement of Account For **1975**

Participants In Individual Retirement Accounts or Annuities

Copy D
For Issuer

Type or print Trustee's or Insurance Company's name, address, ZIP code, and Federal identifying number

Participant's social security number	1 Total value beginning of 1975	2 Contributions in 1975	3 Distributions in 1975	4 Earnings in 1975
		Regular		

For Official Use Only

Form **5499**
Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of
Individual Retirement Arrangement Statements **1975**

Issuer's identifying number	Enter number of documents	Place an X in the proper box to identify type of document being transmitted: Individual retirement Account	Annuity	Statements with distributions	

Type or print ISSUER'S name, address, and ZIP code below (Name must aline with arrow)

Under penalties of perjury, I declare that I have examined this return, including accompanying documents, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature Title Date

16-82500-1

Section 6058(a) of the Internal Revenue Code requires, in part, that every employer maintaining a funded deferred compensation plan "... shall file an annual return stating such information as the Secretary or his delegate may by regulations prescribe with respect to the qualification, financial condition and operations of the plan; *except* that, in the discretion of the Secretary or his delegate, the employer may be relieved from stating in its return any information which is reported in other returns." (Emphasis added.)

In discussion relating to this study, Commission staff considered the possibility of eliminating Form 5329 by allowing the taxpayer to attach Form 5498 (which is similar in purpose to the W-2) to his Form 1040 and indicating his allowed income tax deductions for IRAs on line 40(b). A proposal to consolidate the two forms was made in 1976 at an IRS Tax Forms Coordinating Committee meeting but was tabled.

IRS agreed that there can be discrepancies between the 5329 and the 5498 which can be confusing to taxpayers. However, the IRS believed there was a need to continue the Form 5329 for the reporting of special excise taxes and income taxes on contributions. IRS intends to study the entire issue of reporting contributions because of the provision, effective January 1, 1977, for contributions up to 45 days after the close of the year to be considered excludable from income for the preceding year.

The IRS proposed immediate elimination of the requirement to file the 5498 and the transmitting Form 5499 with IRS Service Centers. The Commission is in agreement with this proposal. This would result in an estimated annual saving of $420,000 to plan sponsors.

Recommendation No. 4
The Commissioner of Internal Revenue should eliminate the requirement to file Forms 5498 and 5499 with the IRS service centers.

Eliminating Forms 5504, 5501, and 5505
Form 5504, "Statement in Support of Deduction for Payment to Defined Benefit and Defined Contribution Plans," is submitted to the Internal Revenue Service to support employer deductions for contributions to pension and/or profit-sharing plans.

The information requested by Form 5504 is mandated pursuant to Treasury Regulation 1.404(a). This requires that a statement be filed which indicates the total amount paid by the employer to the retirement plan, the dates of each payment, and the contribution limitations imposed by law.

The Commission does not question the need of IRS for this information. It is the Commission's understanding that IRS requires the information in order to select for audit the qualified retirement plans. However, Form 5504 may not provide the required audit information. For example, if an employer has two defined benefit plans which have different years — say, July to June and January to December — the number of total employees shown on the separate Forms 5504 covered by the plan will not match the number reported on Form 5501.

In addition, an employer can incur a liability during a taxable year but make a contribution up to the date of filing his tax return. The deduction claimed on an employer's tax return would then not be reconcilable with Form 5504.

In reviewing these discrepancies, IRS offered to consider the elimination of forms 5501 and 5505, as well as the 5504. It does not have the resources to perform audits at this time and thus does not use these forms which are also audit forms. The elimination of forms 5501, 5504 and 5505 would save businesses approximately $11.2 million per year. (See Figures 6, 7 and 8.)

Recommendation No. 5
Because the IRS does not have the resources to perform audits, and because discrepancies may appear between the 5501 and the 5504, the Commission recommends the elimination of Form 5504.

Recommendation No. 6
The Commission endorses the IRS proposal to eliminate Forms 5501 and 5505.

Figures 6, 7 and 8

Elimination of the Internal Revenue Service forms shown in these figures is recommended by the Commission of Federal Paperwork.

Figure 6

Form **5501**

Department of the Treasury
Internal Revenue Service

Summary Statement for Two or More Employee Pension Benefit Plans

Under section 6058(a) of the Internal Revenue Code

▶ **File only with Internal Revenue Service**

1975

This Form is NOT Open to Public Inspection

Taxable year ▶ Calendar year 1975 or fiscal year beginning ____________, 1975 and ending ____________, 19

▶ File this form only if you are an employer who has more than one employee pension benefit plan, other than Keogh (H.R. 10) plans.

▶ Attach all Forms 5500 and 5500–C that report on your employee pension benefit plans.

▶ Please complete every applicable item on this form. If an item does not apply, enter "NA."

1 (a) Name of employer | (b) Employer identification number

Address (number and street)

City or town, State and ZIP code

2 (a) Name of the employer as it appeared on the prior return if not the same as in 1(a) above | (b) Employer identification number

3 Type of employer:
(a) ☐ Corporation (other than Subchapter S)
(b) ☐ Subchapter S Corporation
(c) ☐ Sole proprietorship
(d) ☐ Partnership
(e) ☐ Tax exempt organization
(f) ☐ Trust or estate (taxable)
(g) ☐ Funding exempt organization

	Number of plans	Deduction claimed
4 Summary of plans and deduction claimed on your income tax return.		
(a) Number of Forms 5500 attached and amount of deduction claimed		
(b) Number of Forms 5500–C attached and amount of deduction claimed		
(c) Number of Keogh (H.R. 10) plans, in (a) and (b) above, and amount of deduction claimed with respect to such plans		
5 (a) Total number of employees as of the end of your taxable year		
(b) Total number of your employees who are participating in one or more of your pension benefit plans		

6 (a) Have you closed a plant or division that employed plan participants? . . . . ☐ Yes ☐ No

(b) If "Yes," give the three-digit serial number(s) of the respective plan(s) involved . . . .

(c) Give the three-digit serial number of each plan which you have treated as partially terminated . . . . .

7 Summary of plan reports attached to this return

(a) Plan number	(b) Deduction claimed for contributions made for plan year ending in—		
	(i) Prior taxable year	(ii) Current taxable year	(iii) Next taxable year

General Instructions

(Section references are to the Internal Revenue Code.)

A. Who Must File.—Every employer who has two or more plans of deferred compensation, for which Forms 5500 or 5500–C are filed, must file Form 5501.

B. Employers Not Required to File.—An employer who contributes only to a multi-employer plan, a plan of affiliated corporations or a plan for employees of trades or businesses that are under common control.

C. What to File.—Form 5500 or 5500–C must be filed with Form 5501 for each plan of the employer. Form 5500 or 5500–C is required for each plan for the plan year that ends with or within the taxable year of the employer.

D. When to File.—File on or before the last day of the 7th month following the close of the employer's taxable year.

Note: *The due date for filing this form and all 1975 employee pension benefit plan forms with IRS will be the 15th day of the tenth month following the close of the employer's taxable year.*

You may request an extension of time for filing Form 5501 by writing to your Service Center explaining your need. Generally, the Service will grant an extension up to 45 days if the taxpayer files a timely request which establishes the taxpayer is unable to file by the due date because of circumstances beyond taxpayer's control.

E. Where to File.—File Form 5501 with the Internal Revenue Service Center as set forth in the instructions for Forms 5500 and 5500–C.

F. Signature and Verification.—Form 5501 must be signed by the employer also, by any person, firm or corporation that prepared it for compensation. If prepared by a firm or corporation, it should be signed in the name of the firm or corporation. The signature of a preparer who is a regular full time employee of the employer, is not required.

Specific Instructions

1(b). Enter the employer identification number (EIN) issued to the employer.

2. If the name or EIN of the employer changed during the current year, enter the name and EIN of the employer as they appeared on the prior return (Form 4848).

7. In column (a), enter the three-digit number assigned to the plan.

In columns (b)(i), (ii) and (iii) show the amount of deduction claimed for the current year and indicate what portion of the deduction is attributable to the various plan years.

If additional space is needed, attach additional sheets using the same size paper as this form.

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct and complete. If prepared by a person other than the employer, his declaration is based on all information of which he has any knowledge.

Date ____________ Signature of employer or plan administrator

Date ____________ Signature of individual or firm preparing the return ____________ Preparer's address

Form **5501** (19

Figure 7

Form **5504**

Department of the Treasury
Internal Revenue Service

Statement in Support of Deduction for Payments to Defined Benefit and Defined Contribution Plans

▶ Complete one Form 5504 for each plan.
▶ Attach to Form 5500, 5500-C or 5500-K and file only with Internal Revenue Service.
(Section References are to the Internal Revenue Code)

1975

This Form is NOT Open to Public Inspection

Name of employer | Employer identification number

Name of plan administrator | Administrator's identification number

1 Complete this line only if you are not required to file Form 5501:
(a) Total number of employees of employer . . . .
(b) Amount of deduction claimed for contributions made for plan year ending in:
(i) Prior taxable year . . . .
(ii) Current taxable year . . . .
(iii) Next taxable year . . . .

2(a) Plan name | (b) Plan number

3 Limitation on amount deductible under defined benefit plan:
(a) Amount contributed this taxable year . . . .
(b) Contribution carryover . . . .
(c) Total, (a) plus (b) . . . .
(d) Maximum amount deductible or amount necessary to meet the minimum funding standards . . . .
(e) Deduction claimed . . . .
(f) Were all employer contributions to this plan with respect to the taxable year paid during such year, or not later than the time for filing the tax return (including extensions)? . . . . ☐ Yes ☐ No
(g) Enter the date of the last payment made after the close of the taxable year . . . .
(h) Indicate section of the Code under which deduction limitation was determined:
(i) ☐ Section 404(a)(1)(A)(i)
(ii) ☐ Section 404(a)(1)(A)(ii)
(iii) ☐ Section 404(a)(1)(A)(iii)
(iv) ☐ Section 404(a)(1)(A)
(v) ☐ Section 404(a)(1)(B)
(vi) ☐ Section 404(a)(1)(C)
} Pre Employee Retirement Income Security Act of 1974
(i) Enter the full funding limitation if determined under funding method used . . . .

4 Limitation on amount deductible under profit sharing or stock bonus plan:
(a) Contributions and limitation under profit-sharing or stock bonus plan—
(i) Amount of covered compensation
(ii) Amount of employer contribution for the taxable year . . . .
(iii) Contribution carryover . . . .
(iv) Total of lines (ii) and (iii) . . . .
(v) Enter deduction limitation and indicate whether the limitation was determined under:
☐ Primary or ☐ Secondary limitation
(b) Does the employer have overlapping plans under section 404(a)(7)? . . . . ☐ Yes ☐ No
If "Yes," enter total compensation of all participants under all such overlapping plans . . . .
(c) Enter allowable deduction under section 404(a)(7), if applicable, and attach schedule showing computation . . . .
(d) Did the employer make contributions for each of the preceding five years? . . . . ☐ Yes ☐ No
If "No," enter the year(s) in which no contributions were made ▶ ....
...e all employer contributions to this plan with respect to the taxable year paid during such year, or by ...r than the time for filing the tax return (including extensions)? . . . . ☐ Yes ☐ No
...ate of the last payment made after the close of the taxable year . . . .

Form **5504** (1975)

Form 5504 (1975) Page 2

5 Limitation on amount deductible under money purchase plan:	
(a) Contributions and limitation under money purchase plan—	
(i) Employer contributions paid for the year	
(ii) Contribution carryover from prior year	
(iii) Total contributions subject to limitations, (i) plus (ii)	
(iv) Normal cost (current year's service costs)	
(v) Credits and gains	
(vi) Basic limit on deductions, (iv) less (v)	
(vii) Minimum contributions required under section 412 if larger than (iv)	
(viii) Deductible contribution, larger of (vi) or (vii) but not to exceed (iii)	
(ix) Deductible contributions carried forward, (iii) less (viii)	
(x) Was the plan fully funded as of the end of the year?	☐ Yes ☐ No
(b) Were all employer contributions to this plan with respect to the taxable year paid during such year, or by not later than the time for filing the tax return (including extensions)?	☐ Yes ☐ No
(c) Give the date of the last payment made after the close of the taxable year	
6 Limitation on amount deductible for non-qualified plans under section 404(a)(5):	
(a) Total amount contributed to the plan	
(b) Total amount of (a) that was reported on the participants' Forms W-2 and also non-forfeitable to the participants	
(c) Total amount deductible lesser of (a) or (b)	

General Instructions

A. Who Must File.—Every employer claiming a deduction for the taxable year for contributions made for employees other than self-employed individuals to a defined benefit or a defined contribution plan, whether or not such plan is qualified, must file Form 5504.

Employers who are members of multiemployer plans as defined in section 414(f) are not required to file Form 5504 with respect to such plans.

Each employer of a controlled group of corporations or of common controlled trades or businesses (sections 414(b) and (c)) must file a Form 5504 as an attachment to the Form 5500, 5500-C, or 5500-K filed for the controlled group of corporations or the trades or businesses under common control. However, if a consolidated income tax return (under section 1501) is filed for a controlled group of corporations, only one Form 5504 must be filed for such controlled group.

B. When to File.—This form is to be completed and filed as an attachment to Form 5500, 5500-C or 5500-K whichever is applicable.

C. Employer Name and Identification Number.—The name and employer identification number (EIN) must agree with the name and EIN shown on the Form 5500, 5500-C or 5500-K to which this form is attached.

Employers of a controlled group of corporations and common controlled trades or businesses (section 414(b) and (c)) must furnish the name and the EIN of the plan administrator as they appear on the Form 5500, 5500-C or 5500-K to which the Form 5504 is attached.

D. Plan Identification.—To assure the correct identification of your plans, care must be taken to provide valid numbers and names for each of these entities. They are cross referenced and correlated in the master files of the Internal Revenue Service. The plan number for each plan that you list on this form should correspond to the plan number you used in reporting on this plan on Form 5500, 5500-C or 5500-K.

Specific Instructions

1(b). On lines (b)(i), (ii) and (iii), show the amount of deduction claimed for the current year and indicate what portion of the deduction is attributable to the various plan years.

2(a) and (b). Enter the plan name and plan number as they appear on the Form 5500, 5500-C or 5500-K to which this form is attached.

4(a)(v). The primary limitation is the basic 15% of compensation of all participants. The secondary limitation applies when credit carryovers are used to determine the amount of the allowable deduction. See section 404(a)(3).

U.S. Government Printing Office: 1975—O-[illegible]

Figure 8

Form **5505**

Department of the Treasury
Internal Revenue Service

Statement in Support of Deduction for Payments Made on Behalf of Self-Employed Individuals to Defined Benefit and Defined Contribution Plans

▶ Attach to Form 5500, 5500–C or 5500–K and file only with Internal Revenue Service.

1975

This Form is NOT Open to Public Inspection

Name of employer	Employer identification number
Name of plan administrator	Administrator's identification number

Computation of Allowable Deduction for Employer Contributions Made on Behalf of Self-Employed Individuals

(If more than one plan is involved, combine amounts for all plans and enter result on one form only.)

1 Employer contributions made to the plan for sole proprietor or partners . . . .
(a) Enter dates paid ▶
2 Less amount allocated to life insurance protection (the term insurance premium) . . . .
3 Net contributions . . . .
4 Earned income of sole proprietor and of all participating partners but not in excess of $50,000 for a sole proprietor or for any one partner . . . .
5 15% of line 4. (Sole proprietor, if 15% of line 4 is less than $750, enter lesser of amount on line 4 or $750. Partnerships, if any partner's earned income is less than $5,000, see instructions.) . . .
6 Allowable deduction (lesser of lines 3 or 5). Sole proprietors, enter here and on line 40a, Form 1040 .
7 Did the annual addition with respect to any one participant exceed the lesser of $25,000 or 25% of such participant's compensation? . . . . ☐ Yes ☐ No
8 Plan information

(a) Name of plan	(b) Plan number	(c) Type of Plan (Check applicable column) (i) Defined Benefit	(ii) Defined Contribution
A			
B			
C			

9 Complete only if you are not required to file Form 5501
Total number of employees including self employed . . . .

General Instructions

(Section References are to the Internal Revenue Code)

A. Who Must File.—Every sole proprietor or partnership who has contributed to one or more Keogh plans must file Form 5505 as an attachment to either Form 5500, 5500–C or 5500–K whichever is applicable.

A self employed individual is an individual or partner who has earned income as described in instruction C, from an unincorporated trade, business or profession.

B. Amount of Allowable Deduction.—The overall limitation as shown on line 5 applies to the aggregate net contributions made on your behalf to all plans.

Contributions Made After Close of Your ...'s Year.—You may claim a deduction ... butions made after the close of ... year and by the due date of ... (including extensions) for

Contributions Allocable to Insurance Protection.—For purposes of determining the amount deductible with respect to contributions on behalf of a self employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost for such amount of insurance for the appropriate period. After deducting the amount allocable to insurance protection on line 2, report on line 3 only the net contribution.

C. Earned Income.—Earned income means net earnings from self employment with respect to a trade or business in which personal services are actually rendered. Generally a self employed person may treat his entire share of the net profits of the trade or business as "earned income" even though both personal services and capital are material income producing factors.

Income from Disposition of Certain Property.—For retirement plan purposes earned income includes gains (other than gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created the property.

The net earnings from self employment are the same as those shown on Schedule SE (Form 1040) for self employed individual's or those shown on Schedule K, Form 1065 for each partner of a partnership.

For a more detailed explanation of earned income see section 401(c) and the regulations thereunder.

Specific Instructions

5. If the earned income of one or more partners is less than $5,000, compute an amount for each partner and enter the total on line 5. For partners with earned income of $5,000 or more, the amount to be included on line 5 is 15% of such earned income. For a partner with less than $5,000 earned income the amount to be included on line 5 is the lesser of $750 or the amount of earned income.

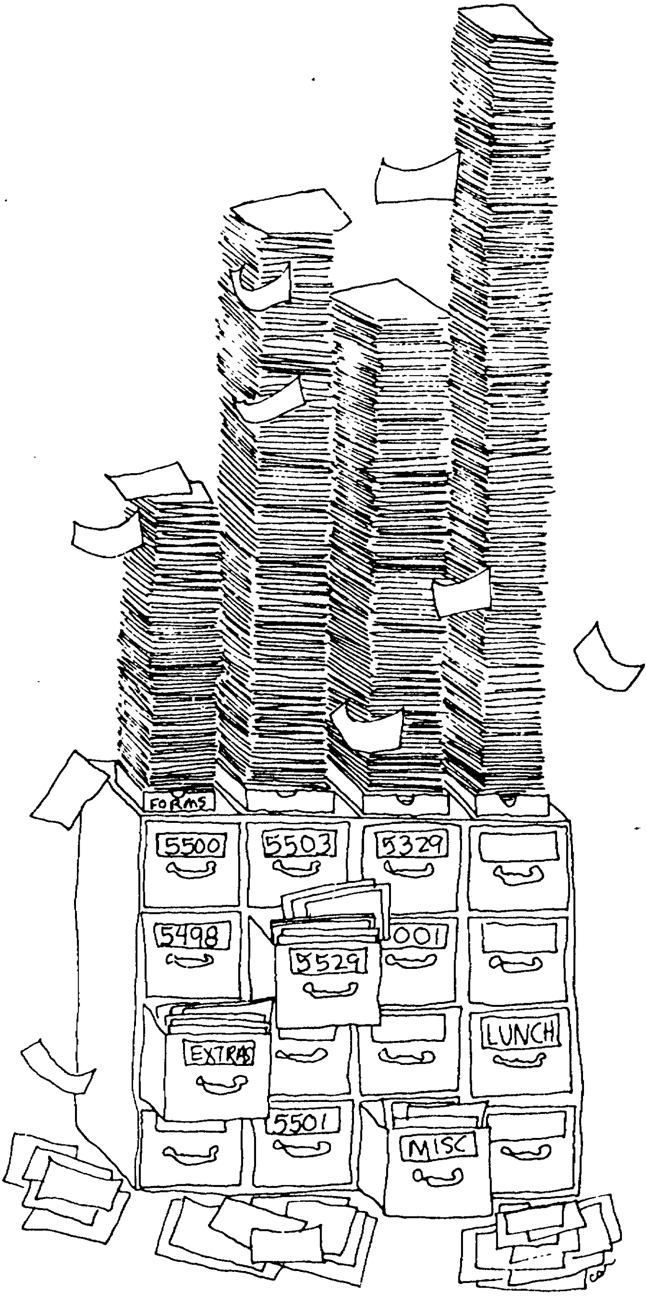
U.S. GOVERNMENT PRINTING OFFICE ...

Form **5505** (1975)

Consistency of IRS Determinations
During the Commission's examination of ERISA reporting requirements, a common grievance was expressed concerning the lack of standardization throughout IRS district offices in making plan determinations. District offices determine whether a plan meets the minimum standards established by ERISA. Without common guidelines, plans which are acceptable in one district office may have to be completely rewritten to satisfy another district office. Problems arise when a professional (whether attorney, certified public accountant, or pension consultant) has clients in different jurisdictions and cannot use standard, IRS-approved language in an employee benefit plan.

IRS recognizes need for consistent guidelines within the national and district offices and is now completing a checklist for use by district offices to standardize the criteria applied in making determinations of approved employee benefit plans.

Recommendation No. 7
The Commission endorses the efforts of IRS to develop a checklist for standardizing criteria used in determinations of the tax status of employee benefit plans.


FORMS
5500
5503
5329
5498
5529
001
EXTRAS
LUNCH
5501
MISC

V.

Coordination of Labor Department and Internal Revenue Service Activities

Title III of ERISA provides for the joint and respective responsibilities of the Department of Labor, the Internal Revenue Service of the Department of the Treasury, and the Pension Benefit Guaranty Corporation.

The dual jurisdiction of DOL and IRS was discussed as follows in the ERISA conference report:[1]

> *One of the thornier problems confronted by the conferees was the question of arranging a workable administrative and enforcement structure that would incorporate the historic role of the Internal Revenue Service with respect to qualified plans as well as the broader role visualized for the Labor Department in terms of safeguarding the interests of participants and beneficiaries and applying its expertise in connection with collectively bargained plans and matters impinging on the field of labor relations. By carefully assigning specific functions to each agency, the Senate bill tended to create a dominant role for each agency and minimize the degree of overlapping. The House bill, on the other hand, created extensive overlapping by assigning duplicate functions, particularly in the areas of the IRS and the Labor Department. However, unlike the Senate bill, the House bill made a deliberate effort to solidify and mutualize the labor and tax interest in pension plans by adopting comparable labor and tax titles to the bill.*
>
> *The final conference agreement represents an effort to adopt the framework of the House bill while also adopting the Senate approach of clearly defining the dominant roles of each agency. Very generally, IRS plays the dominant role in the initial stage of qualifying a plan and administering the participation, vesting, and funding standards. The Secretary of Labor takes the dominant role in protecting the interests of participants and beneficiaries in this connection and*

[1] U.S. Congress. Senate Committee on Labor and Public Welfare. *Legislative History of the Employee Retirement Income Security Act of 1974*. 94th Cong., 2d Session, Committee Print. U.S. Government Printing Office, Washington, D.C., 1976, Vol. III, p. 4770.

91-933 O - 77 - 35

also in the subsequent compliance stage. The Secretary of Labor is also given a precise regulatory role with regard to certain aspects of participation, vesting, and funding which are impressed with a collective-bargaining or labor interest. In addition, the Secretary of Labor is provided the dominant administrative and enforcement role in the areas of disclosure and fiduciary standards, but with respect to prohibited transactions — as well as certain matters relating to qualification of actuaries — there is to be what is tantamount to joint regulation.

Obviously, such an elaborate interweaving of jurisdiction will require the utmost cooperation and coordination between the two agencies in order to avoid exposing the plans to unjustified administrative burdens. . . .

In addition to explicit language concerning jurisdiction, the law acknowledges the necessity for effective coordination by creating a Joint Pension Task Force of the staffs of the Committee on Education and Labor and the Committee on Ways and Means of the House of Representatives, the Committee on Labor and Public Welfare and the Committee on Finance of the Senate, and the Joint Committee on Internal Revenue Taxation.

In the main, the statutory mandate has been followed, but coordination to reduce the paperwork burdens of ERISA could be improved.

Merger of Form EBS-1 with Forms 5300 and 5301

ERISA requires the Department of Labor (DOL) and the Internal Revenue Service (IRS) to share responsibility with respect to qualified private pension plans. Pursuant to section 104(a)(1)(B) of ERISA, the administrators of qualified plans must file a plan description with the DOL on Form EBS-1 within 120 days after a retirement plan has been established. Additionally, information must be filed with IRS on Forms 5300 or 5301 if advance approval, from a tax standpoint, is sought for retirement plans.

Neither the Internal Revenue Code nor Treasury Regulations require that a retirement plan of any type seek advance approval from IRS. However, it is expected that most pension professionals will seek advance approval from the IRS in order to assure that their clients will enjoy current tax deductions for contributions made to a retirement trust, that corresponding current income will not be taxable income to plan participants, and that the trust will be granted tax exempt status.

After a request for determination has been received by IRS, and upon the submittal of Forms 5300 or 5301, the Service issues "Letters of Determination" pursuant to sections 401(a), 403(a) and 405(a) of the Internal Revenue Code. When advance approval is made, under section 3001 of ERISA the IRS must notify the DOL of its finding and also furnish, upon request, information needed for proper administration.

As noted in Figure 9, the information required in the EBS-1 and the IRS Forms 5300 and 5301 is very similar. The basic justification for maintaining two forms has been the fact that employers may not necessarily apply for a determination of tax status, and therefore DOL requires a

separate form. In practice, however, most employers are expected to apply for advance determinations. Moreover, separate forms cause difficulty for employers because the same information is collected in different formats; filling them out is not merely a simple matter of transferring data from one form to another.

Initial discussion with DOL and IRS centered around the possibility of combining the Forms EBS-1 and the 5300. However, it was found that:

- each agency had reasons for maintaining information in its own specialized format.
- the Department of Labor has a need to provide information to the public.
- the Department of Labor does not have an established computer system for processing information received on the EBS-1.
- it is feasible for the IRS to collect the information required on the EBS-1 and forward it to the Department of Labor on a reimbursable basis.
- this would allow the Department of Labor to concentrate its resources on specialized retrieval systems.
- IRS indicated a willingness to have DOL collect the information required on the 5300, if DOL cannot accept information from IRS.

Elimination of the dual and duplicative information requirement would result in an estimated savings of $12 million to business each year, while Government costs would be increased by $180,000 annually.

Recommendation No. 8
To eliminate duplication in information on the Form EBS-1 and Forms 5300 or 5301 requested from pension plan sponsors, the Department of Labor and IRS should come to an agreement to have one agency collect information and forward it to the other agency on a reimbursable basis.

Figure 9

Figure 9 illustrates the duplication among Forms EBS-1, 5300, and 5301. Shaded areas on the EBS-1 form of the Department of Labor indicate comparable questions on the 5300 and 5301 forms of the Internal Revenue Service.

Figure 9

Form **EBS-1**
(FEBRUARY 1976)

U S Department of Labor
Labor Management Services Administration—Office of Employee Benefits Security

Plan Description

Form approved
OMB No 44 - R1596

This form is prescribed under the reporting and disclosure provisions of Title I [of the] Employee Retirement Income Security Act of 1974 (ERISA) Code references are to the Internal Revenue Code of 1954

NOTE Due to the use of certain specialized terms it is important to ref[er to the] instructions on an item by item basis when completing the form Answer each item or enter None or N/A (No[t applicable]) as appropriate

Bold numerals match numbered line on IRS Form 5300 or 5301

A Is this ☐ an initial filing OR ☐ an amended filing

Depart[ment] | A | B | C | D | E | F | G | H | I

B 1 If an amended filing is this
☐ a termination not involving a transf[er of assets or li]abilities to another plan
☐ a transfer of assets or liabilitie[s ... no]t involving a termination
☐ a transfer of assets or lia[bilities ... oth]er plan not involving a termination
☐ another amendment

2 If assets or liabilities were [transf]erred to another plan enter sponsor name EIN and PN for other plan

3 What is the effective date of the amendment? Month | Day | Year

4 Does the amendment result in a reduction of accrued pension benefits to participants? ☐ Yes ☐ No

C What was the date of the latest general distribution of a summary plan description to participants and beneficiaries receiving benefits under the plan?

PART I ALL PLANS

Same as 1(a) above | 2

1(a)

5

3

(b)

3 Check appropriate box to indicate the type of plan entity (check only one box)

(a) ☐ Single employer
(b) ☐ Plan of controlled group of corporation or common control employers
(c) ☐ Multiemployer plan
(d) ☐ Multiple employer collectively bargained plan
(e) ☐ Multiple employer plan (other)

Under penalties of perjury and other penalties set forth in the instructions I declare that I have examined this report including accompanying schedules and statements and to the best of my knowledge and belief it is true correct and complete

Date

Signature of plan administrator

Figure 9 (continued)

[redacted]

10 Is the plan administrator designated as agent for the service of legal process? ☐ Yes ☐ No
If "No," enter the person designated

Name ____________________

Business address (Number and street) ____________________

City, town or post office, State and ZIP code ____________________

11 Indicate the persons who perform functions for the plan. Mark X in all applicable boxes

Bold numerals match numbered line on IRS Form 5300 or 5301

Function	Plan Sponsor (1)	Plan Administrator (2)	Trustee (3)	Insurance Carrier (4)	Other (Specify) (5)
(a) Receives and/or deposits contributions	☐	☐	☐	☐	☐ ________
(b) Maintains records of plan participants	☐	☐	☐	☐	☐ ________
(c) Authorizes payment of plan administrative expenses	☐	☐	☐	☐	☐ ________
(d) Pays plan administrative expenses	☐	☐	☐	☐	☐ ________
(e) Determines investment policy	☐	☐	☐	☐	☐ ________
(f) Invests plan assets	☐	☐	☐	☐	☐ ________
(g) Selects insurance carrier or service organization	☐	☐	☐	☐	☐ ________
(h) Selects corporate trustee	☐	☐	☐	☐	☐ ________
(i) Receives claims for benefits under a plan	☐	☐	☐	☐	☐ ________
(j) Determines eligibility of claimants for receipt of benefits	☐	☐	☐	☐	☐ ________
(k) Determines benefit amount	☐	☐	☐	☐	☐ ________
(l) Makes determination on appeal of claim denials	☐	☐	☐	☐	☐ ________
(m) Authorizes payment of benefits	☐	☐	☐	☐	☐ ________
(n) Makes payments of benefits	☐	☐	☐	☐	☐ ________

NOTE: Information furnished above will not be determinative as to whether a party is a fiduciary to a plan.

[redacted]

FORM EBS-1 (2-76) Page 3

PART II PLANS WITH PENSION PROVISIONS

Figure 9 (continued)

FORM EBS 1-2 76 | Page 4

[redacted]

20 Does the plan have any features of portability or reciprocity with

(a) Employer(s) participating under the plan? ☐ Yes ☐ No

(b) Employer(s) not participating under the plan? ☐ Yes ☐ No

[redacted]

[redacted]

[redacted]

FORM EBS-1 2-76 Page 5

23 Mark X in all applicable boxes for which the plan provides benefits and mark X or otherwise complete information indicating the requirements for attaining the benefits provided

match numbered line
or 5301

Type of Benefit	Requirements for				
	No age or Service (1)	Age Only (2)	Ser (3)	Combination Age and Service (4)	Other (5)
[redacted]					

Form

[redacted]

[redacted]

[redacted]

Figure 9 (continued)

FORM EBS 1 (2-76) Page 6

Bold numerals match numbered line on IRS Form 5300 or 5301

27 What is the disposition of an employee's own contribution if his participation in the plan ends before benefits are received (mark X in all applicable boxes)

	Death (1)	Withdrawal (2)	Disqualification (3)
(a) Contribution returned without interest	☐	☐	☐
(b) Contribution returned with interest	☐	☐	☐
(c) Contribution not returned (explain) ____	☐	☐	☐
(d) Other (specify) ____	☐	☐	☐

PART III PLANS WITH ... PROVISIONS

28 Mark X in all applicable boxes for which the plan prov... mark X or otherwise complete the information indicating the requirements for attaining the benefits provided

Type of Benefit	Requirements for Benefits: Immediate (1)	Waiting Period (specify) (2)	Other (3)
HEALTH			
(a) ☐ Hospital	☐		
(b) ☐ Convalescent care	☐		
(c) ☐ Home health care	☐		
(d) ☐ Surgical	☐		
(e) ☐ Medical	☐		
(f) ☐ Maternity	☐		
(g) ☐ Major medical	☐		
(h) ☐ Dental	☐		
(i) ☐ Prescription drugs (out of hospital)	☐		
(j) ☐ Diagnostic X-ray and laboratory services (out of hospital)	☐		
(k) ☐ Vision care	☐		
(l) ☐ Other health benefit (specify) ____	☐		
OTHER WELFARE			
(a) ☐ Life insurance	☐		
(b) ☐ Accidental death and dismemberment	☐		
(c) ☐ Temporary disability income (accident and sickness)	☐		
(d) ☐ Long term disability	☐		
(e) ☐ Supplementary unemployment benefits	☐		
(f) ☐ Severance pay	☐		
(g) ☐ Apprenticeship and other training	☐		
(h) ☐ Scholarship	☐		
(i) ☐ Prepaid legal services	☐		
(j) ☐ Other (except health) specify ____	☐		

29 Indicate circumstances (other than termination of employment or retirement) causing ineligibility, denial, loss, forfeiture or suspension of welfare benefits

(a) ☐ Illness (c) ☐ Strikes

(b) ☐ Layoffs (d) ☐ Other (specify) ____

PART IV ALL PLANS

[redacted]

Standardization of Filing Dates

Section 104(a)(1)(A) of ERISA requires that the annual report for a plan year be filed with the Secretary of Labor within 120 days after the close of such year. Section 6057(a)(1) of the Internal Revenue Code states: "Within such period after the end of a plan year, as the Secretary of the Treasury or his delegate may by regulations prescribe, the plan administrator of each plan to which ERISA applies shall file a registration statement with the Secretary or his delegate."

In accordance with Title I, the Department of Labor requires that Form 5500 be filed within 210 days of the end of the *plan* year. Title II permits the Secretary of the Treasury to require that an employer file Form 5500 within 210 days of the end of the employer's *taxable* year.

Implications of the lack of standardization can be illustrated by the following example provided to the Commission:

Confused Corporation has a taxable year ending December 31, 1975. Their defined benefit plan, Confused Pension Plan, has a plan year ending June 30, 1976.

By July 31,1976, Forms 5500 and 5504 must be filed with the IRS for the previous taxable year end (December 31, 1975). By December 31, 1976, Form 5500 and Schedule A must be filed with DOL for the previous plan year (June 30, 1976).

In the case of the hypothetical Confused Corporation, there can be as much as a 13-month lag in filing the information with IRS because a 1975 plan year ending June 30, 1975, has a filing deadline 7 months after the taxable year, so that Form 5500 is not filed until July 1976.

Recommendation No. 9
The Commissioner of Internal Revenue and the Secretary of Labor should come to agreement on a single filing date for the 5500 series. Statutory requirements for filing of the Form 5500 should be modified, if necessary, to provide for a single filing date.

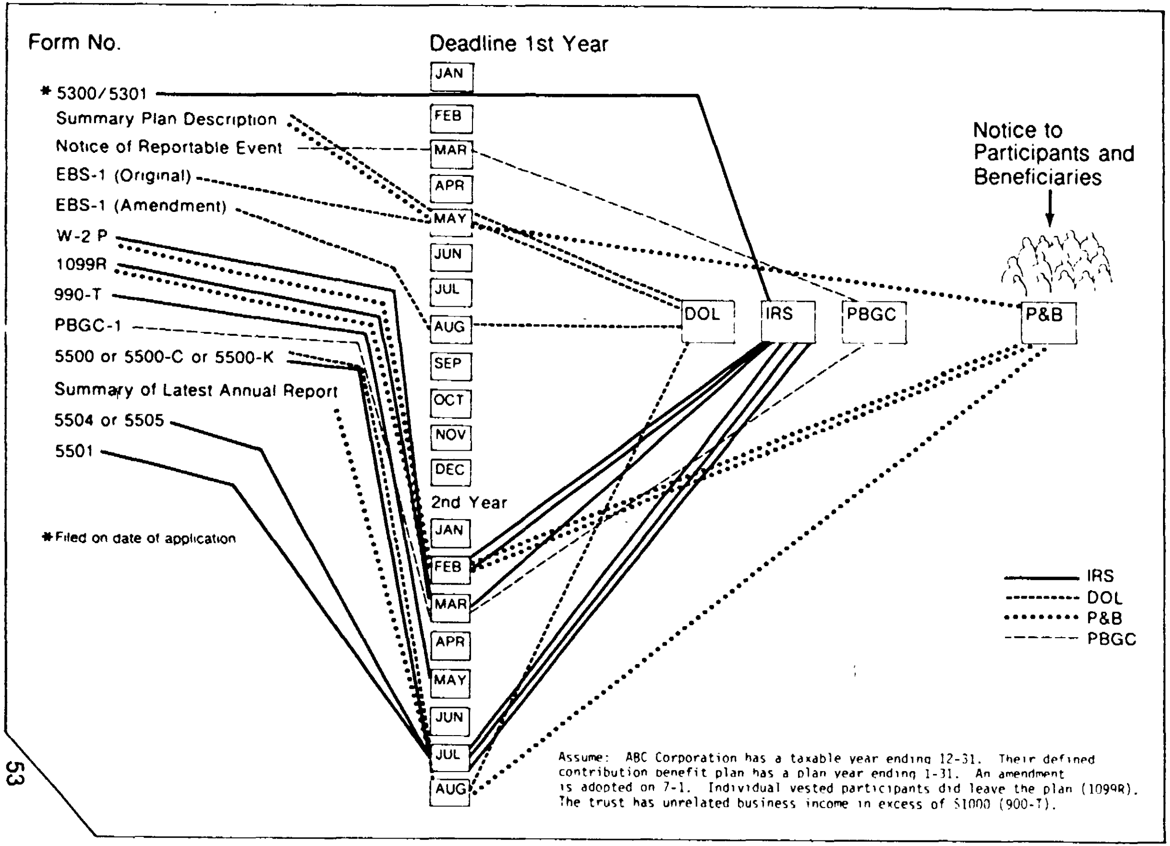
Recommendation No. 10
The Secretary of Labor and the Commissioner of Internal Revenue should jointly re-examine filing date requirements for all pension plan information and institute changes to assure that as much information as possible is submitted on the same date.

Computer Tape Filing of Form 5500
Annual returns/reports of employee benefit plans (Form series 5500) are required by both IRS and DOL under ERISA section 103(a)(1)(A). This report, which covers five pages in the case of plans with one hundred or more participants, contains both financial and statistical information.

Much of the information required for the Form 5500 is contained in the computer files of corporations and could readily be provided to IRS and DOL in the form of computer tapes. This would save the costly and time consuming task of filling out the form.

Figure 10

The chart depicts the multiple filing deadlines required for the various reporting forms which are filed with the Department of Labor, Internal Revenue Service, and Pension Benefit Guaranty Corporation.


Form No.
Deadline 1st Year
* 5300/5301
Summary Plan Description
Notice of Reportable Event
EBS-1 (Original)
EBS-1 (Amendment)
W-2 P
1099R
990-T
PBGC-1
5500 or 5500-C or 5500-K
Summary of Latest Annual Report
5504 or 5505
5501
* Filed on date of application
JAN
FEB
MAR
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
2nd Year
JAN
FEB
MAR
APR
MAY
JUN
JUL
AUG
DOL
IRS
PBGC
P&B
Notice to Participants and Beneficiaries
IRS
DOL
P&B
PBGC
Assume: ABC Corporation has a taxable year ending 12-31. Their defined contribution benefit plan has a plan year ending 1-31. An amendment is adopted on 7-1. Individual vested participants did leave the plan (1099R). The trust has unrelated business income in excess of $1000 (990-T).

Precedents exist for computer tape usage for IRS. Form W-2 is reportable on magnetic tape or disk pack, as indicated in IRS regulations 31.6011(a)-7(b)(2):

> *Permission for use of magnetic tape-(i) Form W-2. In any case where an employer is required by the regulations under this part to submit a copy of a Form W-2 as part of a return or together with an information statement, such requirement may be satisfied by submitting the information required by such form on magnetic tape or by other media, provided that the prior consent of the Commissioner or other authorized employee of the Internal Revenue Service has been obtained.*

This form of application also is allowed for Forms 1087, 1099 and W-3 under IRS regulation 1.9101-1. Not only is tape usage permitted by IRS, it is encouraged, as shown by instructions for filing Form W-3:

> *We encourage employers and other payers with computer capability to use magnetic tape or disk reporting for filing information returns. . . Employers find tape or disk reporting allows economy, efficiency and flexibility.*

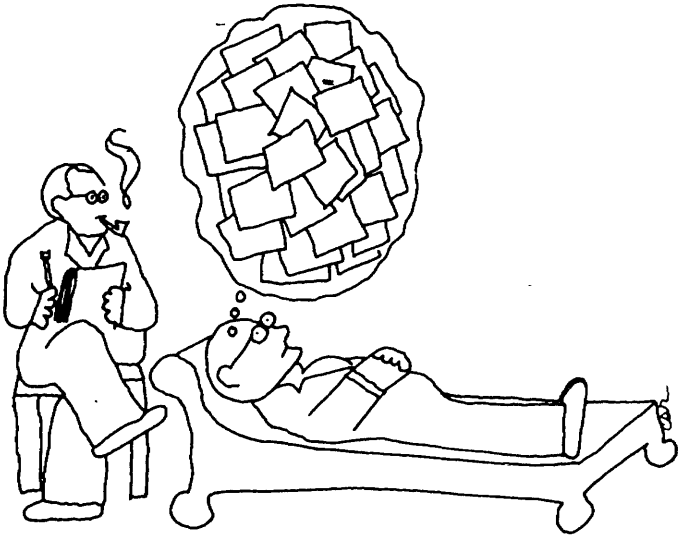
At this time, the Commission cannot estimate the savings that would accrue to business or the Government from adoption of this recommendation.

Recommendation No. 11
The Department of Labor and the Internal Revenue Service should permit the use of appropriate computer generation and interface techniques for report printing and filings, in lieu of filing Form 5500.

IRS-Labor Communication
Plan administrators often have questions when filling out the Form 5500. Presently, administrators have a choice of calling either agency or both to obtain an answer. Complaints received by the Commission indicate that people have experienced problems due to conflicting instructions from the two agencies.

The cause of this problem can be illuminated by a review of relevant provisions of the Act. The first two titles are important in this case. Title I, as one author has pointed out, consists of:

> *. . . a labor law provision repealing and replacing the Welfare and Pension Plans Disclosure Act with a comprehensive labor law providing for reporting and*



disclosure, participation and vesting rules, funding requirements, fiduciary responsibility standards, and administration and enforcement.

He goes on to describe Title II as consisting of:

> *. . . a massive amendment to the Internal Revenue Code establishing new qualified plan requirements corresponding to the requirements set forth in Title I, restructuring the Internal Revenue Service with respect to plan supervision, and establishing new procedures.*[2]

Therefore, ERISA gives similar jurisdiction to two agencies with different basic functions and different perspectives on pensions. When answering questions about a common Form 5500, they are bound to give conflicting answers at times. We recognize that the agencies have not had sufficient time to promulgate the regulations necessary to prevent such conflicts.

One pension expert suggests that a joint IRS-DOL office should be established to answer questions about the Form 550. Plan administrators could call this office, be referred to the proper technical person and, if necessary, take part in a multi-party conference call set up with experts from both agencies.

---

[2]Bildersee, Robert A., *Pension Regulation Manual.* (Boston: Warren, Gorham & Lamont, 1975), p. 1.

Presently IRS uses a referral system to technical experts. Also, there is precedent for IRS-DOL cooperation in ERISA itself. The act, section 3004(a) and (b) states:

> *Whenever in this Act or in any provision of law amended by this Act the Secretary of the Treasury and the Secretary of Labor are required to carry out provisions relating to the same subject matter (as determined by them) they shall consult with each other and shall develop rules, regulations, practices, and forms which, to the extent appropriate for the efficient administration of such provisions, are designed to reduce duplication or overlapping requirements, and the burden of compliance with such provisions by plan administrators, employers, and beneficiaries.*
>
> *In order to avoid unnecessary expense and duplication of functions among government agencies, the Secretary of the Treasury and the Secretary of Labor may make such arrangements or agreements for cooperation or mutual assistance in the performance of their functions under this Act, and the functions of any such agency as they find to be practicable and consistent with law. . . .*

As a result of discussions with IRS and DOL, it is our understanding that an agreement of understanding has been reached to encourage field offices to answer questions relating to the respective jurisdictions of the two agencies. We endorse and encourage this effort.

Recommendation No. 12
The Commission endorses and encourages the agreement of understanding reached by the DOL and IRS to answer questions arising out of their dual jurisdiction and recommends regular review of the adequacy of the existing arrangements.

VI.
Additional Areas of Concern

The foregoing text represents the work completed during this phase of the Commission's ERISA activities. Below is a discussion of areas in which the Commission is presently working and in which continued effort is suggested.

Exemption from Reporting Insurance Commissions and Fees

Under ERISA section 103(e), if some or all of the benefits under the plan are purchased from and guaranteed by an insurance company, insurance service, or other similar organization, a report from such company, service or other similar organization must be filed that covers the plan year and states:

- Premium rate or subscription charge, the total premium or subscription charges paid, and the approximate number of persons covered by each class of benefits.
- Total amount of premiums received and claims paid; any dividends or retroactive rate adjustments, commissions, and administrative services or other fees, etc.; and amounts held to provide benefits after retirement.
- Basis of the premium rate or subscription charge, total of premiums or subscription charges received from the plan, and a financial report of insurance company, service or other organization — to be provided if the insurance organization does not maintain separate experience records covering the specific groups it serves.

The objectives of section 103(e) are, first, to disclose to plan sponsors the amount of premium dollars used for commissions and fees instead of held to provide benefits for plan participants; second, to allow the plan administrator to determine the investment(s) which offer the safest maximum return on investment(s) utilized in the accumulation of plan assets.

The reporting requirements which would call for dollar figures present many problems to the insurance industry. The most significant are: once a policy is issued, commissions that flow from premiums are accumulated with the records of the agent; the flow of commissions into an agent's account does not necessarily coincide with the payment of premium; compilation of the required data in usable form may require either an extraordinary outlay of

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dollars to develop a major computer program or manual collection of the data.

Therefore, on August 3, 1976, DOL issued new regulations specifically relating to these reporting requirements. Section 2520.104-45 of the new regulations grants a "temporary exemption from reporting insurance commissions and fees for plans with fewer than 100 participants."[1]

An alternative method for the reporting of insurance commissions and fees would be to require insurance companies, insurance services, or other similar organizations to furnish current rate schedules which are normally kept by the insurance company and which are directly applicable to the insurance contract(s) of a given plan. Rate schedules should be in a format which will allow the plan sponsor to equate the dollar amount of commissions and fees to the dollar amount of premiums paid for any given type of insurance contract(s) which the plan(s) may have in force.

Commission staff have attempted to obtain rate information from state insurance commissions but have been informed that it is considered contractual information between the agent and the broker. We believe it is in the disclosure spirit of the law that this information be provided to employers and participants, as the cost of commissions is ultimately passed on to the plan sponsor.

Recommendation No. 13
The Department of Labor should work with the Commission on Federal Paperwork to consider the least burdensome method of collecting insurance commission information.

Three Percent Transactions
Section 103 of ERISA requires that all transactions exceeding three percent of plan assets be reported on Form 5500. The purpose of this requirement is to trace major investments. The three percent rule does not fulfill this purpose in many cases, however.

When plans are part of a trust, the reporting requirement is difficult to fulfill because transactions may not be attributable to an individual plan. For small plans, the three

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[1] *Federal Register*, Part II, Department of Labor, Office of Employee Benefit Security, Employee Retirement Income Security: Annual Reporting Requirements, pp. 35523, 35524, (August 3, 1976).

percent rule could entail payments made for supplies or accounting fees reported as plan expense and thus not disclose an investment transaction.

Although the substantive question of the point at which a transaction becomes major is beyond the scope of the study, we do believe an evaluation should be made of this requirement.

Recommendation No. 14
Congress and the Secretary of Labor should work with the Commission on Federal Paperwork to consider alternatives to achieving the purpose of the current three percent reporting requirement of ERISA in a less burdensome manner.

Appendix A

Highlights of the Washington, D.C., Hearing, Commission on Federal Paperwork, January 29-30, 1976

Representative John N. Erlenborn, 14th District, Illinois, testified that the Employee Retirement Income Security Act of 1974 (ERISA) was a unique congressional project intended to protect employee pension benefits, not regulate them out of existence. The act did contain several weaknesses with regard to the gathering of data to study and evaluate the administration of private pension plans. However, regulatory actions have compounded these inherent faults, creating an intolerable burden on respondents while causing many plans to reevaluate their future existence.

For example, the Department of Labor's (DOL) original Form EBS-1, intended to obtain a description of the various pension plans in use, was too lengthy, not computer compatible, and called for essay-style esponses which would have been impossible to process efficiently. Costing approximately $700 per respondent to complete, this form was only one of a series to be issued. Also, in direct opposition to congressional intent, the DOL included a section in its Form 5500 for an accountant's opinion, which could have lead to the termination of many smaller pension plans. Again, this requirement would have been extremely expensive to meet and represented a needless exercise in paperwork as the DOL could not have possibly read each of the two million opinions that would have been filed each year.

Congress reacted to this situation with two separate House subcommittes holding hearings on the matter. As a result, the DOL stated that it would develop a simplified reporting format for pension plans with fewer than 100 participants and that an accountant's opinion would probably not be required from these plans. Continuing congressional oversight of legislative intent is vital to the administration of any program. However, an inordinate amount of congressional time has been spent on the oversight of ERISA, with full-time staff members being assigned to monitor the act's progress.

Representative John H. Dent, 21st District, Pennsylvania, stated that it is purely accidental if there is any relationship between statutory provisions enacted by

Congress and bureaucratic regulations developed to implement them. Federal agencies have no incentive to reduce paperwork because their budgets and staff are justified by the number of forms that are generated, not the quality of information that is received.

Representative Charles A. Vanik, 22nd District, Ohio, said this has resulted in a huge paperwork burden on large and efficient organizations and an almost intolerable burden on smaller businesses. Federal agencies must accept the challenge to gather sufficient enforcement data with the minimum of red tape.

Recommendations made by the Representatives for reducing the paperwork burden imposed by Federal reporting requirements included:

- Expanding the role of Congress and respondents in the drafting of proposed regulations;
- Providing Congress with the authority to review and veto proposed regulations which do not conform with statutory intent;
- Including a Paperwork Impact Statement as part of each congressional committee report;
- Placing greater emphasis on audits instead of traditional reporting methods; and
- Lengthening of the frequency between information requests.

Mr. James D. Hutchinson, Administrator, Pension and Welfare Benefit Programs, Department of Labor, stated that the unrealistic time period provided for the implementation of ERISA's provisions was a major factor in its subsequent problems. Also, the act's statutory language was so complex and exacting in certain instances that it had to be included verbatim in the filing instructions to ensure that respondents provided the correct information. This action, however, only served to increase the dilemma among private pension plan administrators as to exactly what data was being sought. The joint jurisdiction exercised over ERISA by the DOL and IRS has also created administrative confusion. For example, qualified pension plans must meet separate filing requirements of both agencies, However, non-qualified pension funds and all welfare plans are solely responsible to the DOL.

Mario Noto, former staff member, Committee on Labor and Public Welfare, U.S. Senate, testified that future legislation of such complex nature should provide responsible Federal agencies with enough time to establish proper administrative mechanisms before becoming effective. Also, Federal agencies do not require less information than is statutorally required because of the apprehension that Congressional intent will not be fulfilled. One method to avoid proliferation of reporting requests would be to amend statutory requirements to stagger filing after a certain mandatory period. Informal consultation between the requesting agency and the appropriate Congressional oversight committee could also accomplish this goal. If acceptable, this action could lead to the development of an adequate data base during the initial years of an act's enforcement which would only need to be periodically updated thereafter.

Max Weil, President, Max Weil Associates, New York, N.Y., stated the present method by which regulations are proposed and finalized is the single most important cause of the current paperwork burden. It is natural that Federal agencies defend forms and regulations that they have developed and attempt to retain as much of their original content as possible. Furthermore, the Federal Advisory Committee Act makes it difficult for Federal officials to meet informally with respondents and discuss their problems. To alleviate this situation, public advisory committees should be established that are responsible to the appropriate congressional oversight committee, not the administrative Federal agency. These advisory committees should be involved in the total rulemaking process and review all proposed forms and regulations before they are published in the *Federal Register*.

Appendix B

Participants in Working Session for Pension Plan Administrators, Washington, D.C., August 30-31, 1976

Commissioner Donald C. Alexander
Internal Revenue Service
Washington, D.C.

Verne Arends
Northwestern Mutual Life Insurance Company
Milwaukee, Wisconsin

Irving Baldinger
American Benefit Plan Advisor, Inc.
Los Angeles, California

Wayland Coe
U.S. Department of Labor
Washington, D.C.

Robert E. Covington
U.S. Department of Labor
Washington, D.C.

Andrew H. Cox
Ropes and Gray
Boston, Massachusetts

James M. Dawson
James M. Dawson Associates
Manchester, New Hampshire

Peter I. Elinsky
Peat, Marwick, Mitchell & Co.
Washington, D.C.

Joel M. Forster
Ernst & Ernst
Washington, D.C.

Charlie Gardner
Prudential Life Insurance Co. of America
New York, New York

Geoff Gilbert
Ernst & Ernst
Washington, D.C.

Andrew R. Graham
Sybron Corporation
Rochester, New York

Milstead L. Grant
Internal Revenue Service
Washington, D.C.

Cynthia B. Hendrickson
Robert S. Carnachan & Associates
Glendale, California

George Holmes
U.S. Department of Labor
Washington, D.C.

Marion Holmes
Cummins Engine Company
Columbus, Indiana

George L. Huffman, Jr.
A. S. Hanson, Inc.
Chicago, Illinois

Robert L. Jones
M. B. Hariton & Company
Washington, D.C.

Alan Longstaff
Prudential Insurance Co. of America
New York, New York

Stephen Paley
Shefferman, Paley & Rothman
Washington, D.C.

Marion E. Patoukas
Avco Corporation
Greenwich, Connecticut

James E. Reese
Philip Vogel & Company
Dallas, Texas

Donald A. Rowcliffe, Jr.
Chicago District Council
of Carpenters Pension
Fund
Chicago, Illinois

Dianne Schweizer
U.S. Department of Labor
Washington, D.C.

Ira M. Shepard
Committee on Labor and
Public Welfare
U.S. Senate
Washington, D.C.

Carlton R. Sickles
Carday Associates, Inc.
Washington, D.C.

Sol J. Upbine
Arthur Andersen & Co.
New York, New York

Christopher H. Wain
Prudential Life Insurance
Company
New York, New York

Hank Westfall
U.S. Department of Labor
Washington, D.C.

Appendix C

Highlights of the Pittsburgh, Pa., Hearing, Commission on Federal Paperwork, October 14-15, 1976

Steven Marom, Senior Advisor, Employee Benefits Planning, Gulf Oil Corporation, stated that the Gulf Oil Corporation, like other responsible employers, supports the aims of ERISA. Protecting pension plans and keeping employees informed as to their benefits is not only a worthwhile goal, but also sound business practice. Andrew R. Graham, Pension Trust Administrator, Sybron Corporation, Rochester, N.Y., testified that, through its various disclosure requirements, ERISA has attempted to legislate comprehension of the intricacies of the pension system. This cannot be done. Such an attitude fails to recognize the real needs of plan participants and the differences between the various types of pension plans. Instead, the emphasis should be placed on increasing "communication" with participants according to their particular needs.

On the other hand, Thomas Duzak, Director of Pensions, United Steelworkers of America, testified that respondents experiencing difficulties in meeting ERISA disclosure requirements probably had a poor plan to begin with. ERISA should be given the opportunity to complete at least one full reporting cycle before even considering technical amendments to the act, he said.

Max Weil, President, Max Weil Associates, Inc., New York, N.Y., stated that Congress must bear the responsibility for the various paperwork problems created by ERISA. The act failed to acknowledge the various administrative needs and differences between small and large pension plans. Furthermore, the division of regulatory authority between the IRS and the Department of Labor has doubled the regulatory and paperwork burden respondents must bear while tripling their administrative costs.

For example, recent interpretations of ERISA have stated that pension consultants who receive a commission from the sale of life insurance to a client are considered fiduciaries and cannot render administrative services to these clients. Granted, the original intent of ERISA was to prevent certain conflict-of-interest situations involving the fiduciaries of larger pension plans. However, never in the legislative history, nor in the investigations preceding ERISA, have consultants to smaller pension programs been accused of improprieties. If they are forced to choose between administering or selling such plans, the small private pension system will be faced with disaster.

Basic to the overall problem is the manner in which Federal laws and regulations are proposed and instituted, Mr. Weil said. ERISA was designed around what individuals thought the problem was, without the input of professional pension practitioners. Next, ERISA requirements were implemented before effective administrative procedures could be developed or respondents could adequately understand their reporting responsibilities.

In order to prevent this situation from recurring, Federal agencies should be prevented from instituting any regulation with an effective date earlier than 180 days after its promulgation in final form. Furthermore, the Federal Advisory Committee Act should be amended to provide each congressional oversight committee with a public advisory committee comprised of members of the particular industry that they regulate. Moreover, Federal agencies should be required to submit their proposed forms and regulations to these advisory committees before their publication while also allowing them to participate actively in the total rulemaking process.

Appendix D

Highlights of the Miami, Fla., Hearing, Commission on Federal Paperwork, November 19, 1976

Bob Blair, Transnational Financial Planners, Inc., Albany, Ga., testified that each of the Federal agencies responsible for enforcing ERISA's provisions has a different view of the function of pension programs. However, few of the agency officials realize the real reason why pension plans are established. In fact, they often forget that they should be encouraging employers to establish retirement programs. Instead, they concentrate on technicalities which may discourage the creation of new plans and promote the termination of existing pension progrms.

For example, the vesting schedule established by ERISA is much better than the ones previously in effect. However, the IRS, DOL, and Pension Benefit Guaranty Corporation have chosen to discard it in favor of one of their own. Before ERISA an employer contributing $10,000 per year into his company's pension plan would pay out 3.5 percent to 6.5 percent during its first year. Now, however, he must pay between 9.5 percent to 12.0 percent during the initial year. As a result, the employer may have to terminate the plan. Yet, the IRS and DOL will not allow employers to cancel their plans because of ERISA-related costs. Therefore, they must justify their actions on other grounds.

Smaller retirement programs especially are affected by ERISA's provisions and the regulations created to enforce them. For example, the DOL and IRS now propose to prevent pension plan consultants from administering plans or providing services to plan sponsors if they also receive a commission from the sale of qualified plans, even though they acknowledge that the consultant does not function as a trustee or serve as a fiduciary. Many small businesses must rely on consultants to perform administrative duties in order to reduce their costs. If these regulations are enforced, many small pension plans may have to be cancelled because they will be unable to absorb additional costs.

Charles W. Bisset, Vice President, Citibank, New York, N.Y., stated that the real burden of complying with Federal data demands is not having to complete a specific form. Instead, it is the accumulation of unclear filing instructions, seemingly useless reporting procedures, and expensive record retention requirements. Although the purpose of these reporting and disclosure requirements is worthwhile, many of the forms used to enforce ERISA's provisions are poorly designed. For example, the filing instructions for ERISA Form 5500 are vague and, at times, conflicting. As a result, regulators may find it difficult to use the information that they are gathering from respondents. To correct this situation, instructions should be precise and included on the form itself. This would help to eliminate much of the confusion that pension plan sponsors now have in complying with ERISA's provisions.

Many respondents presently face conflicting or duplicative reporting requirements because of the dual administration exercised by the IRS and DOL over ERISA. The Commission's recommendation that they seek to eliminate the collection of redundant data is a step in the right direction. For example, a plan sponsor could complete the EBS-1 for the IRS and attach it to the Form 5300 or 5301. The same EBS-1 could then be filed with the DOL when required. Furthermore, the DOL and IRS should coordinate their filing dates to avoid needless duplication and burden on the respondent. Moreover, both agencies should determine the specific tasks that they are to perform. This goal can be partially achieved by the development of better forms and instructions explaining exactly what data is being sought and the issuance of regulations in a more timely and coordinated fashion.

APPENDIX D

[From the Washington Post, May 15, 1977]

WIDENING PENSIONS' INVESTING

(By Nancy L. Ross)

More than one-third of all the shares of Kaiser Aluminum & Chemical purchased in 1975 were bought by the trust department of one bank, Morgan Guaranty Trust Co. of New York. In that same year, none of 100 pension funds that previously had invested in fledgling businesses did so.

This is an extreme example of concentration of plan assets in blue-chip stocks on the one hand and the drying up of this source of venture capital for the Xeroxes of tomorrow on the other. Both are unintended results of the Pension Reform Act of 1974.

Last week, a Senate Finance Subcommittee held hearings on a bill to remedy this situation by preventing a pension manager from buying more than 5 per cent of any company's outstanding stock (there are no limits now) and, by permitting him to invest up to 2 per cent of a fund's assets in small new companies, something improbable under current regulations.

While the bill was greeted enthusiastically by venture capitalists, Treasury and Labor Department officials expressed fear such leeway for fund managers could endanger workers' benefits.

The concentration occurred as a direct consequence of the Employee Retirement Income Security Act's "prudent man" rule, which increased the liability for fund managers making bad investment decisions. When the International Foundation of Employee Benefit Plans surveyed pension trustees last year, 64 per cent of them stated they were unwilling to invest in anything but blue-chip securities.

As the bill's author, Sen. Lloyd Bentsen (D.-Tex.), put it, "No one is going to bring a suit against a manager because the stock of General Motors or IBM went down the tube, but they might if he had invested in Widget Corp."

Public and private pension funds are big business today. With assets in excess of $445 billion, they are second only to commercial banks. But the funds are managed by a very small number of institutions.

Some 15 bank trust departments, 12 insurance companies and about 24 private financial managers control more than 90 per cent of the pension assets in this country. And they tend to invest in perhaps the same 200 or 300 securities, according to Bentsen.

For instance, Georgetown University Law School, which did a study last year, stated that in the same year Morgan Guaranty's trust department bought 38.5 per cent of the Kaiser stock, it also bought between 25 and 30 per cent of the shares traded of Potlach, International Nickel, Crown Zellerbach and Manufacturer's Hanover. And it sold one out of every eight shares of Philip Morris and Schlumberger's traded in 1975.

Between 1973 and 1975, there were 128 occasions when Morgan, the largest bank trust department, accounted for more than 5 per cent of the total sales and purchases of Big Board issues. On 16 occasions, Morgan accounted for more than 20 per cent, according to the Georgetown study.

In introducing the Pension Investment Act of 1977, Bentsen warned that the potential for manipulation of the market by large institutions could result in "a very substantial reduction of stock prices . . . to the detriment of countless American workers and retirees."

He said, "If one of this very small group of pension managers decides to sell a major investment on a bit of news, and other managers attempt to follow, they find that the 'gate' suddenly gets very narrow."

He has proposed tax penalties to limit investment by a pension fund with more than $1 billion in assets to 5 per cent of a company's outstanding stock. Those with more than 5 per cent already would not be affected. At the same time, pension managers would have the option of investing up to 2 per cent of a plan's assets in new companies with less than $25 million in capitalization without being subject to the prudent man rule. Insurance companies and mutual funds currently are subject to similar regulation.

Besides protecting the safety of pension assets and preventing excess economic concentration, the Pension Investment Act aims to promote greater liquidity in the stock markets and to encourage investment in small, growing companies.

A panel of representatives of venture capital organizations testified that, prior to ERISA's passage, approximately 100 pension funds put up money regularly for fledgling businesses. According to Stewart Greenfield of Charter Oak Enterprises in Darien, Conn., zero pension dollars were received by the 70-odd venture capital firms in the country in 1974 and 1975. In 1976, approximately four funds put up $5 to $6 million.

Another unintentional result of ERISA has been the high rate of plan terminations. Laurence N. Woodworth, assistant Treasury secretary for tax policy, testified that 24,347 pension plans were ended during 1975 and 1976. That was approximately three times as many as in the years prior to ERISA. At the same time, only 30,000 new plans were set up in each of those two years, or just about half as many as in the two preceding years.

One-fifth of the plans were terminated because of the economic and nuisance burden of ERISA, although Woodworth said the real percentage may be higher. (By giving "adverse business conditions" as a reason rather than ERISA, trustees feel they will incur less enmity from disappointed beneficiaries, he said.)

Both Woodworth and Assistant Labor Secretary Francis X. Burkhardt supported legislation that would eliminate duplicative filings to their respective departments. They also backed a companion bill to split administration of ERISA so that vesting and funding would be taken care of by the Internal Revenue Service, while fiduciary responsibility and prohibited transactions would come under Labor's wing. The practical effect of these changes would be to reduce costs and delays, especially for small pension plans.

But William J. Chadwick, a former ERISA administrator now in private law practice, called the existing dual administration "neither efficient nor effective." There are now 40 federal laws and 20 agencies concerned with ERISA. He cited the "absurd" instances where the Labor Department and the Securities and Exchange Commission have argued in court on opposite sides in pension disputes. "This makes the government look stupid," he said.

He cited the case of *Daniel v. International Brotherhood of Teamsters*. A Chicago court held that a participant's interest in a non-contributory pension plan, such as profit-sharing, constituted a security and would therefore be subject to the antifraud provisions of the Securities Exchange Act. On appeal last April, the SEC argued it did constitute a security while the Labor Department argued the participant's share did not.

Chadwick favors a more comprehensive solution, perhaps including a separate government agency for pension plans. Such a bill is pending before a House subcommittee.

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