Nos. 10-56406, 10-56415

In the United States Court of Appeals
for the Ninth Circuit

GLENN TIBBLE, WILLIAM BAUER, WILLIAM IZRAL, HENRY RUNOWIECKI, FREDERICK SUHADOLC, and HUGH TINMAN, JR., as representatives of a class of similarly situated persons, and on behalf of the Plan,
Plaintiffs-Appellants,

v.

EDISON INTERNATIONAL, THE EDISON INTERNATIONAL BENEFITS COMMITTEE, f/k/a The Southern California Edison Benefits Committee, EDISON INTERNATIONAL TRUST INVESTMENT COMMITTEE, SECRETARY OF THE EDISON INTERNATIONAL BENEFITS COMMITTEE, SOUTHERN CALIFORNIA EDISON'S VICE PRESIDENT OF HUMAN RESOURCES, and MANAGER OF SOUTHERN CALIFORNIA EDISON'S HR SERVICE CENTER,
Defendants-Appellees,

On Appeal from the United States District Court for the Central District of California (Stephen V. Wilson, *Judge*), No. 2:07-cv-05359-SVW-AGR

Brief of the **Investment Company Institute** as *Amicus Curiae* in Support of Defendants-Appellees Seeking Affirmance in Pertinent Part

Thomas L. Cubbage III
S. Michael Chittenden
COVINGTON & BURLING LLP
1201 Pennsylvania Ave. NW
Washington, DC 20004-2401
202-662-6000

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Glenn Tibble, et al., Plaintiffs-Appellants/Cross-Appellees,

v.

Edison International, et al., Defendants-Appellees/Cross-Appellants.

Fed. R. App. P. 26.1 Disclosure Statement

The undersigned counsel of record for *Amicus Curiae* the Investment Company Institute hereby furnishes the following information in accordance with Rule 26.1 of the Federal Rules of Appellate Procedure:

The Investment Company Institute has no publicly traded parent corporation.

Dated: August 1, 2011

/s/ Thomas L. Cubbage III
Attorney of Record for
the Investment Company Institute

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

RULES AND REGULATIONS

OTHER SOURCES AND AUTHORITIES

STATEMENT OF INTEREST OF THE *AMICUS CURIAE*

With the written consent of all parties, in accordance with Federal Rule of Appellate Procedure 29(a), the Investment Company Institute ("ICI" or "Institute") respectfully submits this brief as *amicus curiae* in support of Defendants-Appellees.

ICI is the national association of investment companies in the United States. Its members include over 8,500 mutual funds. Since its founding in 1940, one of ICI's main objectives has been to protect and advance the interests of all mutual fund shareholders (including 401(k) plan participants invested in mutual funds) through advocacy directed at ensuring a sound legal and regulatory framework for the mutual fund industry. ICI's legislative, regulatory, and other initiatives focus on increasing government and public awareness of issues affecting investment companies and their shareholders. ICI conducts extensive research on the retirement market and the mutual fund industry, which is used and cited routinely by the Federal Reserve, the Department of Labor ("DOL"), and other regulators.

Mutual funds are a major investment vehicle of choice for fiduciaries and participants in 401(k) plans. Money market mutual funds and collective funds that operate like money market funds frequently appear among the options plans make available to participants that are designed to minimize the risk of losses of principal.

No party to this action authored this *amicus* brief in whole or in part, and neither any party, any party's counsel, nor any other person (other than the Institute or its counsel) contributed money that was intended to fund preparing or submitting this brief. *See* Fed. R. App. P. 29(c)(5).

SUMMARY OF THE ARGUMENT

The Plaintiffs in this action contend, *inter alia*, that decisions to make certain investment options available to participants in the Edison 401(k) plan violated the fiduciaries' duty of prudence under ERISA. Plaintiffs specifically contend that so-called "retail" mutual funds offered by the Plan and the Plan's Money Market Fund would not have been offered by a prudent fiduciary. These contentions disregard the needs of defined contribution plans and important facts about these types of investment options.

Large defined contribution plans such as the Edison Plan typically allow thousands of participants to make and to change investment options as frequently as daily. Those participants include people with varied investment strategies and goals; they typically include some who want to emphasize liquidity in anticipation of an upcoming distribution from the Plan. Because participants are allowed by the Plan to make investment decisions, the availability of information in a readily-understood format can be an important factor in choosing the options provided to them.

Mutual funds are designed to pool the capital of numerous investors in order to assemble a portfolio of investments that meets each fund's stated strategy and objectives. Investors in mutual funds benefit from the protections that stem from the strict regulatory requirements for registered mutual funds under securities laws and SEC regulations. Because mutual funds are designed (and required by law) to meet the transactional and informational needs of numerous investors, mutual funds are well suited for use as investment options for defined contributions plans.

Plaintiffs' argument that what they call "retail" mutual funds should not be offered to plan participants rests upon unfounded premises about the costs and benefits of such mutual funds and their potential alternatives. Research, including data compiled by the Institute, demonstrate that the expenses borne by mutual fund investors in 401(k) plans compare well to alternatives. Moreover, the Court should be wary of misleading comparisons between (i) the expenses of mutual funds, which include not only investment advisory fees but also expenses for other services of value to plan participants,

and (ii) the investment advisory fees (alone) of alternatives such as collective trusts.

Plaintiffs also claim that prudent fiduciaries should not offer money market mutual funds (or short-term investment funds with similar features); instead, they argue, fiduciaries should always opt for stable value funds. Although Plaintiffs claim that stable value funds always provide a better investment return without increased risk to the investor, that argument disregards material differences between stable value funds and money market funds — particularly with regard to liquidity risk. Given the differences, while a prudent fiduciary could decide to offer a stable value fund, that type of investment is not inherently superior (or inferior) to a money market fund or short-term investment fund.

DISCUSSION

I. Introduction

The District Court ruled on many issues. Given limited space, this brief will focus upon the issues involving the appropriateness of certain investments in the plan. While this case should be decided on the basis of its own specific facts, Plaintiffs have made broad categorical

assertions about certain kinds of investment options, arguing that prudent plan fiduciaries should never select either "retail" mutual funds or money market funds as investment options for a large plan. As explained below, the Court should reject those sweeping assertions.

II. Defined Contribution Plans

Before turning to Plaintiffs' arguments concerning investment options offered to participants in defined contribution plans, let us recall important features of those plans.

Defined contribution plans provide benefits to participants based on balances in accounts maintained for each participant. A participant's account reflects her interest in the contributions made to the plan and her share of the plan's investment experience and expenses. The most common defined contribution plans are 401(k) plans.

Most 401(k) plans allow each participant to allocate all or part of the participant's account balance among several designated investment options. Many plans allow participants to elect to change investments as often as daily. Because participants vary in age and other respects, they may prefer different investment styles to achieve varied goals according to their own objectives, risk tolerances, expected retirement

dates, and other savings needs. For example, some participants may be near, or in, retirement and thus seek primarily to preserve capital pending a distribution from the plan in the relatively near future. Yet other participants may be decades away from retirement and favor more growth-oriented investments that are likely to achieve larger aggregate returns over the long term.

In large plans, investment decisions are made individually by thousands of participants, any one of whom may elect to change an investment on any business day. Moreover, once participants become eligible for distributions, they typically are permitted to request that part or even all of their account balances be paid to them.[1] The transactional patterns of participant-directed 401(k) plans therefore differ greatly from those of a typical defined benefit pension plan, which

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[1] In addition to distribution requests by workers who have retired, participants who change employers may elect to take distributions in order to transfer their current 401(k) account balances to an individual retirement account or a new employer's 401(k) savings plan. *See generally* Employee Benefits Research Institute ("EBRI"), *Fundamentals of Employee Benefit Programs* at 90 (6th ed. 2009), *available at* www.ebri.org/pdf/publications/books/fundamentals/2009/08_401k-Pls_RETIREMENT_Funds_2009_EBRI.pdf.

All websites cited in this brief were last visited on July 30, 2011.

invests an aggregate trust fund from which formulaic benefits are paid periodically to retirees.

The investment options offered by 401(k) plans differ from plan to plan, but frequently include a mix of pooled equity or bond investment vehicles, capital preservation products (*e.g.*, money market funds or stable value funds), and employer stock.[2] Because mutual funds offer diversified investment portfolios and provide publicly available information that can help participants make informed decisions, mutual funds are especially popular investment options.

Numerous ERISA provisions and DOL regulations expressly contemplate that plan assets may be invested in mutual funds operated under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* (the "1940 Act").[3] Certain regulations also contemplate potential

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[2] *See* EBRI, *Fundamentals* , supra note 1, at 82.

[3] *See* 29 U.S.C. § 1002(21)(B) (specifying that plan investment in a mutual fund does not make the fund's adviser a plan fiduciary for ERISA purposes); *id.* § 1101(b)(1) (specifying that mutual fund shares owned by a plan are plan assets, but that such mutual fund's underlying investments are not plan assets); 29 C.F.R. § 2509.75-3 (2010) (specifying that "a person who is connected with an investment company … is not deemed to be a fiduciary of or party in interest with respect to a plan solely because the plan has invested in the investment company's shares"); *id.* § 2550.404c-1(e)(1)(i) (2010) (defining mutual

investment choices that emphasize liquidity and capital preservation over long-term growth.[4]

III. Plaintiffs' Sweeping Challenges to Certain Investment Options for 401(k) Plans Are Flawed and Misleading

This lawsuit began with scattershot challenges to many facets of the Edison Plan. Although proceedings in the district court narrowed the issues, Plaintiffs continue to make sweeping contentions and ask this Court, *inter alia*, to rule that it would be inherently imprudent for fiduciaries of large 401(k) plans to make (*i*) retail mutual funds and (*ii*) money market funds available to plan participants. Those contentions ignore or mischaracterize the nature of these investment options and their supposed alternatives.

A. "Retail" Mutual Funds and "Institutional" Investment Options

In the words of the Appellant's First Brief, "Plaintiffs contend that Defendants' use of retail mutual funds as Plan investment options was both imprudent and disloyal … particularly [but not exclusively] as to

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funds as "look-through investment vehicles" for purposes of regulations implementing ERISA Section 404(c), 29 U.S.C. § 1104(c)).

[4] *See*, *e.g.*, 29 C.F.R. § 2550.404c-1(b)(2)(ii)(C)(*2*)(*ii*) (2010) (referring to "an income producing, low risk, liquid fund" investment option).

the mutual funds that had institutional class shares." App't First Br. at 8. They also contend that "while retail mutual funds may be reasonable for individual investors with small amounts to invest, they are unreasonably expensive and poorly performing investments for large, institutional investors such as this multi-billion dollar plan." *Id.* at 31. In response to evidence that employees' union representatives sought mutual fund options, Plaintiffs argue that Defendants were obligated by ERISA to suggest instead "institutional alternatives such as separate accounts or commingled funds in the same variety of [investment] styles …." *Id.* at 32.

For reasons explained below, these contentions stem from false premises, in part because of Plaintiffs' slippery imprecision when referring to "retail" mutual funds and the "institutional" alternatives to which they supposedly compare unfavorably.

1. *Mutual Funds Generally*

A mutual fund is a pool of assets, consisting primarily of a portfolio of securities purchased with capital obtained from the fund's shareholders. *Jones v. Harris Assocs., L.P.*, 130 S. Ct. 1418, 1422 (2010).

The fund's raison d'être is to allow shareholders to collectively and efficiently purchase a diversified and professionally managed portfolio, even if they make relatively small individual investments. Under the management of its investment adviser, a mutual fund assembles its portfolio in accord with stated objectives. These investment objectives, and the styles and strategies to obtain them, can vary greatly — *e.g.*, different types of securities (equity, fixed income, or both), different sizes of targeted enterprises ("large cap," "small cap," etc.), different geographic locations (domestic U.S., emerging foreign markets, etc.), different management styles (index-based versus active management), and so on.

Like other professional services, the investment management services provided by mutual funds are not fungible. Even two mutual funds with the same basic objectives — *e.g.*, two small cap growth funds — can be expected to assemble different portfolios and often achieve materially different investment results. Thus investment management resembles other professional services, such as medical and legal services, whose providers are not interchangeable.

In addition to investment management, mutual funds provide numerous other services to shareholders, including communications with shareholders, compliance with myriad regulations, and accounting services. Required by law to provide daily pricing[5] and daily redemption,[6] mutual funds typically build or contract for the technological capacity to handle purchase, redemption, and exchange orders of thousands of shareholders daily and to provide ongoing recordkeeping and customer service to large numbers of investors. Mutual funds incur expenses for providing all of these services to shareholders.

Mutual funds are governed by all of the major securities laws, including the 1940 Act, the Securities Act of 1933, and implementing regulations. These laws govern, *inter alia*, mutual fund capital structure, custody of fund assets, and how funds value their portfolios. This regulatory framework holds advisers and fund boards to fiduciary standards, strictly regulates conflicts of interest, and imposes disclosure rules with the needs of ordinary investors in mind. Those disclosure

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[5] 17 C.F.R. § 270.22c-1(b)(1) (2011).

[6] 15 U.S.C. § 80a-22.

rules require that each mutual fund provide shareholders a prospectus containing extensive information about the fund's organization, fees and expenses, investment strategy, investment risks, and past performance, as well as a summary prospectus that discloses the key information in plain English and in a standardized format. These valuable protections are among the reasons that mutual funds are highly favored by individual investors as well as corporations and other institutions.

2. *"Retail" and "Institutional" Investment Vehicles*

In attempting to establish "retail" as a shorthand and pejorative label, Plaintiffs have mischaracterized how mutual fund fees work and incorrectly suggest that "retail" mutual funds are essentially the "expensive" funds.

First, all mutual fund investments (including those in "institutional share classes" of mutual funds) have features characteristic of investments in "retail" products. All mutual funds must be capable of interacting with and serving large numbers of shareholders. Moreover, *any* kind of investment vehicle that a 401(k) plan offers to thousands of individual, decision-making participants —

whether or not it is a mutual fund — takes on a "retail" character in that setting. Thus, in the 401(k) plan setting, even trust fund vehicles such as "separate accounts" and "commingled funds" must take on, or be complemented with the services of other vendors to provide, many of the same characteristics as "retail mutual funds."

Second, contrary to Plaintiffs' implied suggestion, individual 401(k) plan fiduciaries cannot negotiate pricing with mutual funds. The securities laws require each and every shareholder in a particular share class to incur the same expense ratio as every other shareholder in that class.[7] Mutual funds may establish distinct share classes within the fund, where the components of the expense ratio other than the advisory fee (*e.g.*, administrative expenses, distribution fees, and loads, if any) may vary, but the Securities and Exchange Commission ("SEC") requires the fund to charge the same advisory fee to each and every share class (and thus to all shareholders) in the same fund.[8] Where the fund decides to establish separate share classes — and many do not —

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[7] The effect of negotiating a discount for certain shareholders would be a senior security to those shareholders, which is prohibited by the 1940 Act. 15 U.S.C. § 80a-18(f).

[8] 17 C.F.R. § 270.18f-3 (2011).

one share class may be labeled the "institutional" class because it is designed for a segment of the market requiring fewer services and distribution expenses. But no investor in any particular share class may negotiate with a fund or its adviser for a lower fee.

Moreover, simply because a share class is called "institutional" does not guarantee that it has lower fees than retail funds (or retail share classes) with similar investment objectives. The expense ratios of "institutional" mutual fund share classes are sometimes well above the expense ratios of a "retail or general purpose" share class of another fund in the same asset category. For example, the average expense ratio of no-load institutional funds or share classes of equity mutual funds offered for sale in 2010 was 1.10 percent. But the asset-weighted average expense ratio incurred by 401(k) investors in no-load "retail or general purpose" share classes of equity mutual funds in 2010 was 0.69 percent — fully 37 percent less.[9] In other words, 401(k) plan fiduciaries

[9] Sarah Holden, Michael Hadley, and Shaun Lutz, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2010*, at 10 (ICI 2011), *available at* www.ici.org/pdf/per17-04.pdf.

and participants tend to seek out lower-cost mutual funds, regardless of the label attached to those funds.

Plaintiffs also challenge the selection of mutual funds rather than alternatives to registered mutual funds, such as trust accounts. These trust accounts may take the form of a separate account (holding a single plan's assets) or a collective trust or commingled pool (holding multiple plans' assets).[10]

These trust accounts, however, are not governed by securities laws such as the 1940 Act or 1933 Act.[11] As the Supreme Court observed, the important protections these laws provide for investors require mutual funds to incur the costs of satisfying "more burdensome regulatory and legal obligations" than other investment vehicles must satisfy. *Harris Assocs*., 130 S. Ct. at 1428-29.

Moreover, the court should be wary of inapt comparisons, because the services that separate accounts and collective trusts provide may

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[10] ICI, *Mutual Funds and Institutional Accounts: A Comparison*, at 1 n.2 (2006), *available at* www.ici.org/pdf/ppr_06_mf_inst_comparison.pdf.

[11] *Id*. at 5. Moreover, unlike trust account managers, broker-dealers that sell mutual funds must comply with the Securities Exchange Act of 1934 and the advisers to mutual funds must comply with the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq*.

differ from those of mutual funds. While some providers of trust accounts can provide services such as daily individual account valuation, customer service, or communications for individual participants, providing those services *in addition to* investment management will entail additional fees.[12] Consequently, comparisons of only the investment advisory fees of different investment vehicles are misleading. *Harris Assocs.*, 130 S. Ct. at 1429 ("If the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison.").

B. Money Market Funds, Short-term Investment Funds, and Stable Value Funds

Another investment choice that Plaintiffs challenge on appeal is the availability of what the Edison Plan called the "Money Market Fund," managed by State Street Global Advisors[13] — the "option for participants to earn interest with the lowest risk of loss of their

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[12] ICI, *Mutual Funds and Institutional Accounts*, at 9 (observing that, generally, "if an institutional investor such as a defined benefit pension plan offers beneficiaries an Internet website or a call center to handle inquiries, the costs of providing those services are not encompassed in the advisory fees that the institution pays for investment management").

[13] *Tibble v. Edison Int'l*, 639 F. Supp. 1074, 1081 (C.D. Cal. 2009) ("*Tibble S.J. Order*").

investment." App't First Br. at 9. According to Plaintiffs, "Defendants imprudently used State Street's STIF [short-term investment fund] instead of a stable value fund that provides higher interest at the same low risk …." *Id.*; *see also id.* at 15 (asserting that "a stable value fund could have provided higher returns at the same low risk of loss"). By convention, a "money market fund" is a pooled investment vehicle that invests in short-term, highly liquid securities and is registered under the 1940 Act.[14] An SEC-registered money market fund must comply with Rule 2a-7 under the 1940 Act.[15] By convention, a short-term investment fund ("STIF") is a pooled investment vehicle, such as a collective investment fund, that is not registered with the SEC under the 1940 Act, but generally falls under banking regulations.[16] STIFs

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[14] *See generally Harris Assocs.*, 130 S. Ct. at 1426 n.6 ("A money market fund often invests in short-term money market securities, such as short-term securities of the United States Government or its agencies, bank certificates of deposit, and commercial paper. Investors can invest in such a fund for as little as a day ….").

[15] 17 C.F.R. § 270.2a-7 (2011) ("Rule 2a-7").

[16] STIFs and Money Market Deposit Accounts are sometimes colloquially referred to as money market funds. STIFs are trust accounts regulated by the Office of the Comptroller of the Currency. *See* 12 C.F.R. § 9.18(b)(4)(ii)(B). Money Market Deposit Accounts are deposit accounts regulated by the relevant banking laws and regulators.

may voluntarily adopt investment principles that correspond to Rule 2a-7. In the case of State Street's STIF, the fund declaration imposes limits on credit quality based on the most stringent standards of Rule 2a-7 and incorporates diversification standards and limitations on maturity for a single security that track similar requirements in Rule 2a-7.[17]

Plaintiffs' sweeping assertion that stable value funds will consistently provide higher returns than STIFs or money market funds but without increased risk not only defies economic common sense, but disregards the distinct features of the different types of investments. Money market funds, STIFs, and stable value funds can all be appropriate investment options for a 401(k) plan, but they are not fungible products.

For a discussion of various financial intermediaries in the money market, including money market funds, *see* ICI, *Report of the Money Market Working Group*, at 16-29 (2009), *available at* http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[17] This STIF's fund declarations, as amended effective 2003 and 2007, were admitted in evidence at trial as exhibits 1019 and 1177. *See* District Court Docket Nos. 315, 374 (exhibit lists, indicating that exhibits 1019 and 1177 were admitted in evidence).

Money market funds, STIFs, and stable value funds are investment vehicles that all seek to minimize the risk of principal losses rather than maximize investment returns. These funds can provide important protections for participants who plan to withdraw money from a 401(k) plan in the near future or who are nearing retirement. The three products, however, have different features and risk profiles that caution against directly comparing them.

All three options are available in many 401(k) plans and account for sizeable percentages of participants' investments in those plans. At year-end 2009 (the most recent data available), on average, 5.3 percent of the value of 401(k) plan accounts was in money market funds (or similar investments including STIFs) and 12.6 percent was in guaranteed investment contracts ("GICs") or stable value funds.[18]

1. *Compliance with Rule 2a-7*

Money market funds must operate in accordance with Rule 2a-7, which sets forth numerous requirements for money market funds that

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[18] Jack VanDerhei, Sarah Holden, and Luis Alonso, *401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2009* at 25 (2010), *available at* www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No350_401k_Update-092.pdf.

are designed to limit credit, maturity, diversification, and liquidity risk.[19] In addition, investors in these funds benefit from the regulations applicable to mutual funds discussed above, including laws relating to disclosure and communication, accounting, custody of fund assets, and redemption requirements.[20]

The protections provided by Rule 2a-7 restrict the securities held by money market funds so as to limit the potential for a loss of principal. For example, money market funds are required to hold securities that pose minimal credit risks. In general, a money market fund may hold only securities that are rated in or of comparable credit quality to one of the two highest short-term rating categories.[21] In addition, 97 percent or more of the securities held by a money market

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[19] For a brief explanation of these risk-limiting requirements, *see* ICI, *Summary of Money Market Fund Regulatory Requirements* (2010), *available at* www.ici.org/mmfs/background/11_mmf_reg_summ.

[20] *See supra* Part III.A.1.

[21] Rule 2a-7(c)(3).

fund are required to be rated in or of comparable quality to the highest short-term rating category ("first tier securities").[22]

A money market fund also is required to diversify its holdings so as to protect investors from large losses related to any single issuer. In general, a money market fund may invest no more than 5 percent of its assets in the securities of any single issuer (other than securities issued by the U.S. government) and may invest no more than 0.5 percent of its assets in second tier securities issued by any single issuer.[23]

To further limit investor risk, Rule 2a-7 permits a money market fund to invest only in securities of short duration.[24] A money market fund cannot acquire a first tier security with a remaining maturity of greater than 397 days or a second tier security with a remaining

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[22] Rule 2a-7(c)(3) provides that a security held by a money market fund may be considered a first tier security (and excluded from the three-percent limit on "second tier securities") if it is subject to a demand feature or guarantee that is itself a first-tier security and meets certain other conditions.

[23] Rule 2a-7(c)(4).

[24] Rule 2a-7(c)(2).

maturity of greater than 45 days.[25] In addition, to reduce both interest rate and credit spread risk, the dollar-weighted average maturity of securities held by a money market fund may not exceed 60 days, and 120 days determined without reference to certain exceptions for interest rate adjustments.[26]

Money market funds also are designed to provide significant protections from liquidity risk. Rule 2a-7 requires a money market fund to maintain at least 10 percent of its assets in cash and securities that are readily convertible to cash within one business day.[27] A money market fund also must maintain at least 30 percent of its assets in cash or securities that are readily convertible to cash within five business days.[28]

Although STIFs are not registered mutual funds that are bound by Rule 2a-7, such investment funds nonetheless may voluntarily follow

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[25] *Id.* Some exceptions exist for variable and floating rate securities that have an interest rate reset in no more than 397 days and those with a demand feature. Rule 2a-7(d).

[26] Rule 2a-7(c)(2).

[27] *See* Rule 2a-7(c)(5).

[28] Rule 2a-7(c)(5).

some or all of the standards found in Rule 2a-7 when choosing guidelines for issues such as credit quality, diversification, and duration to maturity. As noted above, the STIF offered to participants in the Edison Plan followed standards closely akin to Rule 2a-7 at the time of the fund declarations.

In exchange for so limiting their portfolio holdings, Rule 2a-7 permits money market funds to value portfolio securities at amortized cost, which helps allow them to report a stable share price, typically $1.00 per share, provided the fund's mark-to-market value remains between $0.9950 and $1.0050.[29] Returns are distributed to money market fund investors as dividends that are usually reinvested in additional shares. Money market funds also must periodically compare the amortized cost net asset value of the fund's portfolio with the mark-to-market net asset value of the portfolio and report their market-based values to the SEC monthly; those reports become public after a 60-day delay.[30]

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[29] Rule 2a-7(c)(8)(ii)(B).

[30] 17 C.F.R. § 270.30b1-7 (2011).

Money market funds generally provide low-cost investment options to 401(k) investors. In this case, the district court found that the STIF offered by the Edison Plan had an expense ratio of just 8 basis points (0.08%) at the time of trial.[31]

2. *Stable Value Funds*

Like money market funds and STIFs, stable value funds are a capital preservation investment option available in many 401(k) plans. They generally invest assets in diversified fixed-income securities of longer duration than STIFs and money market funds and are designed to provide somewhat higher returns. To guard against the increased credit, investment, and liquidity risk inherent in longer duration securities, the funds enter into contracts with banks and insurance companies that smooth out the volatility of the funds' fixed-income investments.

Stable value funds can be structured either as a separately managed account for an individual 401(k) plan or as a commingled fund

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[31] *Tibble v. Edison Int'l*, No. CV 07-5359 SVW (AGRx), 2010 WL 2757153, at *16 (C.D. Cal. July 8, 2010).

containing assets of multiple 401(k) plans.[32] The contract protection against volatility is provided through one of three investment instruments (or a combination of them): (1) a GIC in which the invested assets are owned by an insurance company and held in the insurance company's general account and participants' accounts are credited with a specified rate of return; (2) a separate account contract in which the invested assets are owned by an insurance company and are held in a separate account solely for the benefit of the contract holder and participants' accounts are credited with either a fixed rate of return or a period rate of return based on the investment performance of the underlying assets; or (3) a synthetic GIC in which the invested assets are held in the 401(k) plan's trust and "wrapped" with a separate contract from a bank or insurance company.[33]

The regulatory regime for stable value funds depends on how the fund is organized. Funds offered by banks are subject to regulations issued by the Office of the Comptroller of the Currency. Funds offered

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[32] Stable Value Investment Association, *Your Questions Answered About Stable Value* (Mar. 23, 2009) ("SVIA Questions Answered"), *available at* http://stablevalue.org/help-desk/faq/.

[33] *Id.*

by insurance companies (and aspects of wrap contracts) are regulated by state insurance departments. In addition, stable value funds offered in 401(k) plans generally must comply with accounting rules issued by the Financial Accounting Standards Board ("FASB") to use book value accounting. However, no comprehensive rules governing the quality and types of securities that may be held by stable value funds exist.

Similar to the allowance in Rule 2a-7 for amortized cost method accounting in money market funds, stable value funds that meet certain requirements are permitted to use book or contract value — contributions plus accrued interest less withdrawals and fees — for deposits, withdrawals, and transfers.[34] A fund's book value may diverge significantly from its actual market value and there is no requirement that the book value stay within a corridor around the market value, such as that which exists for money market funds.

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[34] FASB, FASB Staff Position No. AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans* (Dec. 29, 2005), *available at* www.fasb.org.

Depending on their particular structure, a given stable value fund may offer higher returns than a particular STIF or money market fund. A U.S. government report, however, has found that increasing stable value fund returns from 2005 to 2007 were due in part to an increase in the holdings of higher risk securities by those funds.[35] Stable value funds increased holdings in highly rated corporate bonds, mortgage-backed securities, and asset-backed securities while reducing their holdings of cash and U.S. government securities.[36] The loss of value in those securities during the recent market turmoil will reduce future participant returns as stated interest rates are lowered to recoup losses on earlier withdrawals.[37] In addition, new restrictions on the securities held in stable value funds combined with increased cash positions in

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[35] U.S. Government Accountability Office ("GAO"), *401(k) Plans: Certain Investment Options and Practices that May Restrict Withdrawals Not Widely Understood* at 25 (2011) ("GAO Stable Value Report"), *available at* www.gao.gov/new.items/d11291.pdf .

[36] *Id.*

[37] *Id.* at 25–26; *see also* FASB, Derivatives Implementation Group, *Statement 133 Implementation Issue No. A16: Definition of a Derivative: Synthetic Guaranteed Investment Contracts* (Mar. 14, 2001) (discussing adjustment of future rates to account for market value below book value), *available at* www.fasb.org/derivatives/issuea16.shtml&pf=true.

response to the declining availability of wrap contracts may limit the potential for returns near recent highs.[38]

While in the normal course, stable value funds transact at book value, there are certain situations where the divergence between book and market value can result in withdrawals being processed at market value. These situations, such as security defaults or downgrades that can cause a sudden steep drop in market value, are typically included in the contracts between the plan (or fund) and the insurance or banking company.[39] Other "employer-initiated" events, such as layoffs, bankruptcies, mergers, acquisitions, early retirement programs, plan terminations, or changing from one stable value fund to another, also can result in a fund transacting at market value rather than contract value.[40]

Stable value funds also expose participants to other risks that are unique to the way in which the funds are structured. In addition to

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[38] GAO Stable Value Report, *supra* note 35, at 29. These restrictions are being imposed, in many cases, by the contract providers and plan sponsors. *See also* Eleanor Laise, *'Stable' Funds are Looking Shakier*, Wall St. J., May 1, 2010, at B8.

[39] SVIA Questions Answered, *supra* note 32.

[40] GAO Stable Value Report, *supra* note 35, at 24.

losses that may be incurred if a stable value fund's wrap protection is voided due to an employer-initiated event, an insurer default or withdrawal from the market may result in the loss of contractual protection.[41]

In addition, employer-initiated events may also result in plan participants and plan sponsors being subject to withdrawal restrictions.[42] For example, as a result of an employer's bankruptcy, participants in one 401(k) plan were restricted from withdrawing their assets from the plan's stable value fund.[43] Plan fiduciaries may also be unable to remove a plan's stable value fund from the investment line-up: one plan sponsor reported that it was restricted from withdrawing from a stable value fund for nearly 2 years as the result of a corporate merger that took only 4 ½ months to complete.[44] These types of restrictions are largely designed to protect remaining participants in

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[41] *Id.* at 28.

[42] *Id.* at 24.

[43] *Id.*

[44] *Id.*

comingled stable value funds.[45] Plans using a separate account structure often cannot withdraw from a stable value fund at book value while book value exceeds market value.[46]

In most cases, participants are able to continue to withdraw their investments from a stable value fund even if the plan sponsor is restricted from making withdrawals. However, participants are almost always subject to restrictions on the investments into which they can transfer funds from stable value plans.[47] In the majority of cases, participants cannot transfer 401(k) funds from a stable value fund into a short-term bond fund or money market fund.[48] New stable value contracts may also restrict transfers into popular investment options such as target date funds and brokerage windows.[49]

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[45] *Id.*

[46] *Id.*

[47] Paul J. Donahue, *Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market*, 39 AKRON L. REV. 9, 21-22 (2006).

[48] GAO Stable Value Report, *supra* note 35, at 28.

[49] *See* Laise, *supra* note 38.

Recent changes also have raised the cost of stable value funds. Wrap contract costs have increased from rates as low as 0.06 percent to as high as 0.25 percent in the past few years as the result of fewer providers offering wrap contracts and a perceived increase in the risk to the contract provider.[50] Rising costs for wrap contracts have the effect of reducing participant returns in stable value funds. Lower returns have led some plan fiduciaries to reassess their decision to offer stable value funds.[51]

In sum, although particular stable value funds may have provided higher rates of return in recent years than particular money market funds or STIFs, those higher returns reflect greater investment risks and more limited ability of investors to redeem their holdings. For plan participants seeking an income producing, low risk, and liquid fund — and for the fiduciaries of a large plan that may have hundreds or thousands of such participants at any time, including participants anticipating distributions in the near term — the choice between stable

[50] *Id.*; *see also* GAO Stable Value Report, *supra* note 35, at 29.

[51] *See* Laise, *supra* note 38 (noting The Employees Retirement System of Texas's decision not to renew its contract with its stable value provider due to falling returns).

value funds on one hand and money market funds and STIFs on the other is not, as Plaintiffs contend, an apples-to-apples comparison. Prudent fiduciaries might choose one, or the other, or both.[52]

CONCLUSION

In resolving these cross-appeals, the Court should reject Plaintiffs' characterizations of mutual funds, money market funds, and STIFs. None of these types of investment option is inherently imprudent for large 401(k) plans.

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Respectfully submitted,

/s/ Thomas L. Cubbage III
Thomas L. Cubbage III
S. Michael Chittenden
COVINGTON & BURLING LLP
1201 Pennsylvania Ave. NW
Washington, DC 20004-2401
202-662-6000

Counsel for *Amicus Curiae*
the Investment Company Institute

[52] *See Tibble S.J. Order*, 639 F. Supp. 2d at 1118 (citing survey evidence in the record on the extensive use of money market funds by defined contribution funds).

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