

PUBLIC

JAN 27 1993

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 93-39-CC
County of Los Angeles
File No. 132-3

Your letter of January 19, 1993, requests our assurance that we would not recommend that the Commission take any enforcement action against the County of Los Angeles (the "County"), the County's Deferred Compensation and Thrift Plan (the "Plan"), or the Plan's funding vehicles under the registration provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940 if the County changes the administration of the Plan in the manner described in your letter.

The Plan is a deferred compensation plan under Section 457 of the Internal Revenue Code. Section 457 generally permits state and local governments to create plans under which their employees may defer receipt (and thus taxation) of a portion of their current compensation until separation from service. The section provides, however, that plan assets must remain "solely" the property of the employer, "subject only to the claims of the employer's general creditors." 1/

Participation in the Plan is voluntary. Employees may contribute a portion of their earnings each month up to a maximum of \$7,500 a year. 2/ Employees are also permitted to direct their contributions among five independently managed investment options: the Money Market/Depository Fund, the Balanced Fund, the Stock Index Fund, the Growth Equity Fund, and the Stable Income Fund (the "SIF"). Approximately 75% (or \$750 million) of Plan assets is currently invested in the SIF. Of this, approximately \$50 million is invested in a guaranteed interest contract issued by the Protective Life Insurance Company, while the balance is invested in a separate account contract issued by the Metropolitan Life Insurance Company.

The County proposes to create a new investment option, the Los Angeles County Investment Fund ("LACIF"). 3/ The LACIF will be under direct County management and will invest primarily in securities backed by income producing County property. The County contemplates that the securities will be certificates of participation, backed either by a specific revenue stream or by the general credit of the County. The total amount of Plan

1/ Section 457(b)(6).

2/ In the past, the County has made matching contributions for each dollar contributed, up to 2.5% of earnings. Matching contributions, however, are currently suspended.

3/ All other existing Plan investments and administrative arrangements will remain in place.

assets that may be allocated to the LACIF will be capped at approximately \$200 million and the life of the LACIF will be limited. The County will bear the costs associated with the creation of the LACIF.

In connection with the creation of the LACIF, the County proposes to provide participants with supplemental Plan literature and an election form. The supplemental literature will advise participants that they will have a one-time opportunity to allocate all or any portion of their current Plan account balance from any existing Plan investment option to the LACIF. The literature will also clearly and prominently disclose, at or near the beginning, the nature and terms of a 457 plan, including all the risks associated with this type of plan and the distinction between the "vesting" of participant contributions and participant "ownership" of Section 457 plan account balances. In addition, the literature will explain the role of the LACIF in meeting the County's budget needs.

Participants will receive the supplemental literature and election form at least 30 days before the LACIF begins operating. Transfers to the LACIF will not be permitted after the election period. No transfer to the LACIF will be made unless a participant affirmatively opts in by filling in the election form. With the exception of the LACIF, the County will maintain all of the Plan investments under independent, external management.

You represent that "no part of the corpus or income of the Plan will be used for, or diverted to, purposes other than the exclusive benefit of participants or their beneficiaries, provided, however, that all Plan assets will remain subject to the claims of the County's general creditors to the minimum extent required by Section 457." 4/

4/ We note that the County previously has taken the position that the County has very limited access to these funds. See Letter from Sandra M. Davis, Treasurer and Tax Collector, County of Los Angeles, to Hoyle L. Robinson, Executive Secretary of FDIC (Feb. 12, 1990), expressing the view that the County's rights to these funds was based on a "fragile technicality that these funds actually belong to the employer." See also Letter from David J. Tirapelle, Director, Department of Personnel Administration, State of California, to Hoyle L. Robinson (Mar. 12, 1990) ("in no instance has the State utilized funds on deposit for 457 plan participants to bail out from a budget deficiency. The State believes these funds are owed employees and treats them accordingly"); Letter from John Dark, Treasurer and Tax Collector, County of Sacramento, to Hoyle L. Robinson (Mar. 8, 1990) ("Do counties believe that they own the Plan assets?

On the basis of the unique facts and representations in your letter, and without agreeing with your legal analysis, we would not recommend that the Commission take any enforcement action against the County, the Plan, or the Plan's funding vehicles under the registration provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940 if the County changes the administration of the Plan in the manner described in your letter. The Division of Corporation Finance and the Division of Market Regulation have asked us to advise you that they concur with the position of the Division of Investment Management. Because the Divisions' position is based on the facts and representations in your letter, you should note that different facts or representations might require a different conclusion. Further this response only expresses the Divisions' position on enforcement action and does not purport to express any legal conclusions on the questions presented.



Thomas S. Harman
Associate Director
(Chief Counsel)

No! the ownership language in Section 457 is viewed as a legal fiction").

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January 19, 1993

1933 Act Section 3(a)(2); 1934
Act Section 3(a)(12); and 1940
Act Section 3(c)(11)

BY HAND DELIVERY

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Mail Stop 10-6

Abigail Arms, Esq.
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Chief Counsel
Division of Corporation Finance
Mail Stop 3-3

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: County of Los Angeles Section 457 Plan

Dear Meses. Smythe, Arms, and Cross and Mr. Harman:

Our client, the County of Los Angeles ("the County"), is considering various emergency steps to address a projected shortfall in its fiscal 1992-93 operating budget in order to avoid potentially catastrophic consequences for County residents. One proposal currently under consideration is to create a new investment option under the County's Deferred Compensation and Thrift Plan ("the Plan") pursuant to Section 457 of the Internal Revenue Code ("the Code"). This new option would permit Plan participants who elect to do so to effect a one-time transfer of all or a portion of their account balances to a County-administered fund which would purchase County securities, such as securitized real property leases or installment sales agreements. This

Act	ICA 1940
Section	3(c)(11)
Rule	
Public	
Availability	11/21/93

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proposal would permit the County to finance some of its most pressing service needs and to avoid discharging substantial numbers of its employees, while providing Plan participants with an investment option focussed on local municipal assets.

As you are aware, this proposal has been the subject of extensive and fruitful discussion between the staff and representatives of the County, including this Firm. This letter sets forth the results of those discussions. On behalf of the County, we ask that the staff assure us that, if the County proceeds with its proposal in the manner set forth in this letter, the staff will not recommend that the Commission take enforcement action under the registration requirements of the Securities Act of 1933, of the Securities Exchange Act of 1934, or of the Investment Company Act of 1940 against the Plan, the County, or the various unregistered funding vehicles for the Plan.

A. Background

Section 457 of the Code permits state and local government employers to create plans under which their employees may defer receipt (and thus taxation) of a portion of their current compensation until separation from service. Unlike most other tax-favored savings plans, however, Section 457 plans are not "qualified" within the meaning of Section 401(a) of the Code, and the ability of employees to exclude from income the sums allocated to such plans depends on the plan being structured such that the employee has not, for tax purposes, actually received any interest in the plan.¹

¹ In this regard, Section 457 of the Code provides that all deferred compensation, all property and rights purchased therewith, and all income attributable thereto, "shall remain (until made available to the participant or beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the employer's general creditors." The Treasury Department has, however, permitted, by regulation, Section 457 plans to provide that a participant may direct the investment of the amount of assets in the plan attributable to his or her deferred compensation into particular funding vehicles, such as mutual fund shares or insurance company contracts. See Treas. Reg. § 1.457-2(j).

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The Los Angeles County Section 457 plan is styled "Horizons -- The Deferred Compensation and Thrift Plan." Participation in the Plan is voluntary.² Under the Plan, employees may contribute from one to 25 percent of their eligible earnings each month to the Plan, up to a maximum of \$7,500 per year. In the past, the County has made matching contributions in the amount of 75 cents for each dollar contributed, up to 2.5 percent of earnings; matching contributions are currently suspended.

Consistent with Regulation 1.457-2(j), supra note 1, an employee may direct the investment of Plan assets equal to his or her interest in the Plan among five independently managed investment options -- the Money Market/Depository Fund; the Stable Income Fund ("SIF"); the Balanced Fund; the Stock Index Fund; and the Growth Equity Fund. Transfers, up to one per month, among investment options are permitted; these occur without charge, except that transfers to the Money Market/Depository Fund are subject to a 7 percent transfer fee.

Presently, roughly 75 percent (approximately \$750 million) of the aggregate Plan account balances are held in the SIF. Of this amount, approximately \$50 million is invested in a guaranteed interest contract issued by the Protective Life Insurance Company ("Protective Life"), and the balance (approximately \$700 million) is invested in a separate account contract issued by the Metropolitan Life Insurance Company ("MetLife"). All Plan record-keeping and participant interface is handled by Bankers Trust Company under a contract with the County.³

B. The Proposal

The proposed change in the administration of the Plan involves the creation of a new investment option, the Los Angeles County Investment Fund ("LACIF"). Subject to the limitations described

² The Los Angeles County Employees Retirement Association provides County employees with a separate, nonvoluntary retirement program.

³ Specifically, Bankers Trust maintains records of participant account balances, provides written materials to participants, and processes participant transactions, including Plan withdrawals, changes in participant investment or beneficiary designations, etc.

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below, each Plan participant will be entitled to allocate all or a portion of his or her existing account balance to the LACIF. The LACIF will have similar characteristics to the SIF, but will be administered directly by the County. All other existing Plan investments and administrative arrangements will remain in place. The details of the County's proposal are set forth below.

1. Creation of the LACIF

The LACIF will be under direct County management. The County proposes to administer the LACIF primarily by selling to it County securities backed by income-producing County property. It is initially contemplated that these securities will be certificates of participation ("COPs"), backed either by a specific revenue stream or by the general credit of the County.⁴ To the extent that

⁴ In the first case (revenue-backed securities), the County would sell an existing revenue-producing property to a non-profit corporation ("NPC") indirectly controlled by the County. The NPC would immediately sell the property back to the County pursuant to a conditional sales contract under which the County would be obligated to make periodic installment payments, a portion of which would be designated as and constitute interest. The NPC would assign its rights to receive the County installment payments to a trustee bank, which would be instructed to execute and deliver to the NPC COPs representing fractional, undivided interests in the County installment payments. The NPC would sell the COPs to the SIF. The proceeds of sale of the COPs received by the NPC would be paid to the County as consideration for the purchase of the property by the NPC. The revenues derived by the County from the property would be pledged to the payment of the installment payments, and the general funds of the County would not be obligated to make such payments if the revenues were insufficient.

In the second case, the County would lease one or more buildings to the NPC, which would immediately sublease the buildings back to the County. The County would be obligated to pay rent to the NPC from its general funds each year, in consideration for the use and occupancy of the buildings. A portion of each rent payment would be designated as and constitute interest. The NPC would assign its rights to receive rent under the sublease to a trustee bank, which would be instructed to execute and deliver COPs as described in the previous example. The proceeds of sale of the COPs received by the NPC would be paid to the County as advance

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the LACIF is not invested in COPs or similar County securities, it will be invested in liquid money market instruments in accordance with the County's policies for investing excess cash.

The total amount of Plan assets which may be allocated to the LACIF will be capped, and the life of the LACIF will be limited. The County presently contemplates that the cap on allocations to the LACIF will be approximately \$200 million.⁵ Further, the cap will gradually decrease to zero over some period of time (probably in the range of ten years). At the end of the life of the LACIF, any remaining balance will be transferred to the SIF, unless participants select another investment option.

The County will agree to credit participant account balances allocated to the LACIF with a rate of return more attractive than the rate credited to SIF accounts. This may be accomplished by setting a guaranteed minimum LACIF rate of return greater than the minimum SIF rate; by providing that the LACIF will provide the same rate of return as the SIF rate, plus a specific premium; or in some other manner. While the exact method of calculating the LACIF return has not yet been determined, the objective will be to provide a return "sweetener" that will attract Plan participants to the LACIF.

2. Disclosure and Participant Election Process

In connection with the creation of the LACIF, each Plan participant will be sent supplemental Plan literature describing the change in Plan investment options. All current Plan participants will also receive an election form. This disclosure will advise participants that they will have a one-time opportunity to allocate all or any portion of their current Plan account balance from any existing Plan investment option to the LACIF. It will also explain the County's fiscal 1993 budget needs, the role of the LACIF in meeting those needs, and the options available to

rent under the lease from the County to the NPC.

⁵ The amount of the cap will be approximately \$150 million, plus an amount sufficient to allow for anticipated participant-directed transfers out of the LACIF. While we currently believe that this cushion will be approximately \$50 million, the actual amount will be determined by studying the transfer experience of the SIF.

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the County in the event that the LACIF is not funded to the full amount of its cap.⁶ In addition, this new material will include language at or near the beginning of such material which clearly and prominently informs participants of the nature and terms of a Section 457 plan; of all of the risks to which the assets of such a plan are subject; and of the distinction between the "vesting" of participant contributions and participant "ownership" of Section 457 plan account balances. The County will bear the expenses associated with the creation of the LACIF, with the preparation of the Plan disclosure documents necessitated by the creation of the LACIF, and with the LACIF election process.

The election period for allocations to the LACIF will be at least 30 days. That is, participants will be sent the notice and election form at least 30 days before the LACIF actually commences operations. Following the LACIF election period, LACIF participants will be permitted to transfer all or any portion of their account balances out of the LACIF in accordance with the same rules as govern the existing Plan options. Under those rules, participants may transfer out of any investment option and into another once per month, subject only to any pre-disclosed transfer fees. However, unlike other investment options, transfers (or the allocation of future deferred income) to the LACIF will not be permitted after the LACIF election period.

As described above, the LACIF will be subject to a cap. In the event that requests are received during the LACIF election period to allocate account balances to the LACIF in excess of the cap, all account balances allocated to the LACIF will be accepted prorata. Thus, for example, if the LACIF is capped at \$200 million, and participants elect to allocate \$300 million to the LACIF during the LACIF election period, 2/3 of the amount each participant sought to allocate to the LACIF will be accepted. The portion of each participant's account which is not accepted into the LACIF will be allocated to other Plan investment options in accordance with the participant's direction; in the event that no direction is made, the sums not accepted into the LACIF will remain in the investment option from which such sums were to have been transferred.

⁶ We also anticipate that the unions representing County employees will encourage Plan participants to elect to allocate some portion of their Plan balances to the LACIF.

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3. Safeguards and Limitations

As a safeguard to Plan participants, the County is committed to Plan disclosure that will permit Plan participants to exercise an informed choice concerning whether or not to place all or a portion of their Plan account balances in the new LACIF investment option. As additional safeguards, the County has authorized us to represent, as a condition to the relief sought in this letter, that, except with respect to the operation of the LACIF as described above --

(a) the County will maintain all of the Plan investments under independent, external (rather than County) management; and

(b) no part of the corpus or income of the Plan will be used for, or diverted to, purposes other than the exclusive benefit of participants or their beneficiaries, provided, however, that all Plan assets will remain subject to the claims of the County's general creditors to the minimum extent required by Section 457.

C. Relief Requested

We believe that the foregoing proposal is consistent with the federal securities laws, to the extent those laws apply to the Plan. As you are aware, the Plan and the interests of participants therein are not registered under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940. In our view, the implementation of the proposal as set forth above will not require the Plan to register nor will it require the Plan or the County to register the interests in the Plan. Similarly, in our view, the implementation of the proposal as set forth above will not preclude any funding vehicle for the Plan from relying on the exemptions from Securities Act, Securities Exchange Act, and Investment Company Act registration provided by, respectively, Sections 3(a)(2), 3(a)(12), and 3(c)(11) of those Acts, provided and to the extent that those exemptions are otherwise available to such funding vehicles.

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Accordingly, we request that the staff advise us that it will not recommend enforcement action against the County, the Plan, or the funding vehicles for any Plan investment option under the registration provisions of the Securities Act of 1933, of the Securities Exchange Act of 1934, or of the Investment Company Act of 1940 if the County implements the proposed revisions to its Section 457 plan described herein.

* * *

We appreciate the staff's cooperation and assistance in connection with this important matter. If you have questions concerning this request, please contact David S. Ruder in Baker & McKenzie's Chicago office at (312) 861-3733 or Daniel L. Goelzer in the Firm's Washington office at (202) 452-7013.

Sincerely,

Baker & McKenzie /dley

Baker & McKenzie