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RETIREMENT SECURITY: PICKING UP THE ENRON PIECES

HEARING

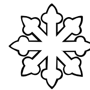
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 27, 2002



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RETIREMENT SECURITY: PICKING UP THE ENRON PIECES

WEDNESDAY, FEBRUARY 27, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:04 p.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Breaux, Bingaman, Lincoln, Grassley, Nickles, Snowe, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Technically, this hearing is about the Enron case and its implications for pension policy, but it is really much more than that.

At the most fundamental level, this hearing, among others that Congress will be conducting, is about confidence. All across this country, the story of Enron has shaken public confidence in our system, raised questions about accounting, questions about securities, analysts' opinions, banks, credit lines, business ethics, our tax laws, our pension laws. The question is, what do we do about it?

As is often the case, most of the solutions will probably come from the private sector. That is, banks will tighten up credit, securities analysts in the wake of Enron will hopefully be a little bit more careful. Accountants will be certainly scrutinizing companies more closely, probably asking for more disclosure. At least, I hope they do. Generally, that is what happens in America.

But we also, though, clearly have a role in government. That is, what should our pension laws provide? Should it be the subject of another hearing? What should the accounting and tax treatment of offshore tax havens be? There are lots of questions here, but we have to strike a balance.

It sort of reminds me of many years ago when I was talking to a professor at Carroll College, a small college in Montana, he said, all American political thought can be summed up in two sentences. Number one, get the government off my back. Number two, there ought to be a law about that. That is basically where we are.

That is, we want freedom. People need freedom to make their own choices, invest in the companies they want to invest in, whether to buy company stock or not in their pension plan.

On the other hand, we want to make sure there are some guidelines. Particularly in civilized societies, we need guidelines to help

create some order. That's the attention that we are focusing on here today in trying to find that right balance.

With that in mind, let us turn to the specifics. We all sympathize with Enron's rank-and-file workers. They thought they had dreams. They worked in the company that they thought was a good company, a company that was praised for its innovation. Then they saw that dream crumble. In many cases, a lifetime of retirement savings turned to dust.

If there's a bright line in this tragic story, it is this. Sometimes it takes a crisis to galvanize into action that otherwise would not be possible. However, there are many, many people whose life savings are gone, and that is a tragic situation that we have to deal with, that is galvanizing.

For example, 25 years ago, the giant auto company Studebaker went bankrupt, leaving thousands of retirees and workers without the pensions they had been promised. This led to the creation of the Pension Benefit Guaranty Corporation.

Today, as a result of that, millions of workers know that they can depend on a predictable benefit when they retire. There has also been a significant change. More and more, the traditional pension plan, the so-called defined benefit plan, has been replaced by defined contribution plans like 401(k)s.

This is partly a reflection of fundamental changes in our economy. Workers today change jobs more often that they used to, and 401(k) plans are designed to move with them when they do so.

Today, 42 million workers depend on 401(k)s for their retirement security. This is over one-third of our workforce. Assets held by these plans have grown from $74 billion in 1975 to over $2 trillion today.

They are not guaranteed like defined benefit plans, but they can produce big benefits. As the stock market rises, 401(k) account balances grow along with it. But there is a down side, which the Enron case demonstrates. Workers can be left with no nest egg at all to show for a lifetime's worth of work. Just ask people who worked at companies like Enron, Lucent, and Polaroid. They will tell you that the risk of disaster is very real.

So as I said at the outset, we need to strike a balance. We have to figure out how to protect workers' investments in defined contribution plans without imposing so many rules and regulations that we regulate them right out of existence.

Today's hearing is a first step. We want to find out what went wrong with Enron's pension plans. We also want to find out whether Enron is an isolated case or whether it reflects a broad, systemic problem.

Let me mention a few specific issues that I hope we can get into. First, Enron's workers were highly concentrated in their company's stock, but they bought much of that stock voluntarily.

This raises a question: should we impose limits on a worker's ability to buy employer stock, even when workers themselves have good information to make that choice themselves?

Second, Enron's workers couldn't sell company-matching stock until they reached 50 with 10 years of service. We need to understand how many other workers are subject to these same limits, and whether they still make sense in today's investment climate.

Third, Enron instituted a black-out period while it was changing plan administrators. During that period, workers couldn't change their investments and they had to sit by watching helplessly as their 401(k) funds lost more and more of their value.

If we impose statutory limits on these black-out periods or impose liability on employers and plan administrators, will that help workers or will it hurt them?

Fourth, many workers had investment advice available to them and ignored it, while other workers do not have advice available and would like it. Is there a way to make good investment advice available to workers without putting them at more risk?

Finally, much of Enron's stock was held in the form of an employer stock ownership plan. ESOPs are great ways to help workers own a piece of the company they work for. They can help small companies raise capital and avoid hostile takeovers. But do we help or hurt workers when an ESOP is the only retirement plan they have?

There have been a number of bills introduced to address these, and other issues, and I expect more. Members of our committee are among those who have introduced bills, including Senator Grassley's, as is being introduced today.

I think it is important to understand the pros and cons of the proposals that they represent as we search for a consensus that is good for workers and good for the country.

I know this hearing and those to follow, of which there will be several, will help Congress find the right balance that will protect and expand pension coverage for America's workers.*

Senator Grassley?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman, for holding a hearing on a subject that I think we would all agree we should not have to have, but because of consequences of people being immoral and unethical in their approach to corporate leadership has brought us to this point. That involves the Enron and Global Crossing controversies.

Since these have erupted, I have been concerned about the larger consequences these bankruptcies have for retirement plans across our country.

What we have learned about so far, and will continue to explore, are problems with manipulation of employer stock in these retirement plans. Based on what we know today, I am going to be introducing legislation which I hope will enjoy wide support after the members of both parties have an opportunity to study my approach. Consequently, I have looked at the issues of consensus and included them in a bill.

Among other provisions, it involves new diversification rules for company stocks in plans, improved disclosure prior to black-outs and clarification of fiduciary requirements, parity between treat-

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*For more information on this subject, *see also*, "Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements and Proposals Regarding Defined Contribution Plans," Joint Committee on Taxation report, dated Feb. 27, 2002 (JCX–11–02).

ment of rank-and-file workers during a black-out, and executive stock trading rights, better information for participants through periodic benefit statements, and retirement education and information.

I have spent a lot of my years in this committee and other committees to help Americans save more for retirement, particularly the baby boom generation, a generation that saves less than any previous generation.

In fact, Mr. Chairman, you and I introduced legislation only last year that made very dramatic differences in people's ability to save for their retirement. Those provisions were part of the Tax Relief Act enacted and signed by the President last June.

So it is especially tragic that, at both Enron and Global Crossing, workers lost so much retirement money while the top executives were lining their pockets with gold. I have Enron subsidiary employees in my State, so my interest is not in the abstract.

The Internal Revenue Code gives substantial tax preferences to companies that sponsor retirement plans. In exchange, the plans have to be operated in compliance with the Internal Revenue Code and the Employee Retirement Income Security Act.

This committee has exclusive jurisdiction over the Code and over significant portions of ERISA. As a result, this committee, the Senate Finance Committee, ought to take action and exercise its jurisdiction to guard against abuse.

One of our jobs is to exercise our oversight responsibilities to see that strong enforcement programs are in place by Treasury, the IRS, and also the Labor Department.

We have to make sure that certain programs protect workers, the government, and financial markets against manipulation and against abuse.

And, by the way, Mr. Chairman, speaking of enforcement programs at the Labor Department, I am sorry that the Assistant Secretary for Pensions could not fit this meeting into her schedule. I think it would have added a lot to the hearing to have a representative from the Department of Labor here.

In addition to oversight, our other job is to legislate, and maybe not more important than oversight, either. But we have to make sure that our laws do what we say they are supposed to.

I suppose we would all look back at everything on the books now and say that, if the spirit of those laws had been followed, then surely Enron could not have happened. But it did happen.

So these jobs of oversight and legislation must be carried out in the context of our present environment, and also within the context of a voluntary retirement system. Our responsibility is to legislate. That is why I am introducing the National Employees Saving and Trust Equity Act, the acronym NESTEG, for short.

I think current law can be improved, so I took this action of introduction. I did this because what I believe may have been unfair restrictions on stock and retirement plans that ultimately cost some unsuspecting workers their retirement benefits, money for which tax benefits were given.

But I have been criticized by some because I try to be either nonpartisan or bipartisan in this approach. There are those who would want to interject contentious issues in the retirement legislation

and I do not think that we can go that way and get done what needs to be done soon because of the Enron and Global Crossing situations.

I have included the items where I think there is general agreement. But where there is not, I will let the field lie fallow, as we farmers say. I realize there have been discussions about preventing the Finance Committee from exercising its jurisdiction over retirement plans and handing this issue to the Labor Committee.

I know of no reason why we should cede jurisdiction in this area, so I hope that our committee will move quickly to report legislation that will extend protections and tax penalties where they are needed. That is, before there are more Enrons and more Global Crossings, and more dashed hope of secured retirement for a lot of workers who were depending upon their benefits from 401(k)s. Thank you, Mr. Chairman.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator Grassley.

I would now like to introduce our witness, Comptroller General of the General Accounting Office. Mr. Walker, we are very pleased to have you here.

I want to remind our colleagues and those listening that you have got a background in this area, having written a book entitled, "Retirement Security: Understanding and Planning your Financial Future," you have also served as a public trustee for the Social Security and Medicare, as well as serving as Assistant Secretary of Labor for Pension and Welfare Benefit programs, and Acting Executive Director for the Pension Benefit Guaranty Corporation.

So, we are very honored that you are here and look forward to your testimony. Your full statement will be included in the record.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, sir.

Mr. Chairman, Senator Grassley, other Senators, thank you very much. This is a topic in which I have had longstanding interest and involvement, and I do appreciate the opportunity to appear before this committee.

As you noted, Mr. Chairman, my full statement has now been entered into the record, so therefore I will briefly summarize the key points. I want to be able to provide as much time as possible to answer any questions that you may have.

I am pleased to be here today to provide you with our preliminary observations on some of the challenges facing the Nation's private pension system. When I say "our," I mean GAO's.

The financial collapse of the Enron Corporation and its effect on the company's workers and retirees suggests certain vulnerabilities in selected savings mechanisms.

Enron's retirement plans, which included a defined benefit cash balance plan, a defined contribution 401(k) plan, and an ESOP, has caused Congress to question specifically the use of employer stock as the company match, the continued existence of floor offset arrangements, and the practice of investment freezes or lock-downs during changes in plan administrators.

The financial losses suffered by participants in Enron's retirement plans have raised concerns about the benefits and limitations of such private pension and savings plans, and the challenges employees face in saving for retirement through their employer-sponsored plans.

In summary, the collapse of the Enron Corporation and the accompanying loss of Enron employees' retirement savings appear to highlight certain vulnerabilities in the private pension system and should help to focus attention on the need to strengthen several aspects of this system.

Diversification of pension assets is critically important, particularly in a world where the use of defined contribution plans, those where the employees bear the investment risk, is increasing rapidly.

If both the employee's 401(k) contributions and the company match are largely in employer stock, as was the case in connection with Enron—and as you noted, Mr. Chairman, in some cases voluntarily, in some cases because of plan design—employees risk losing not only their jobs should the company go out of business, but also a significant portion of their retirement savings.

The Enron collapse, although not by itself evidence that private pension law should be changed, served to illustrate what can happen to employees' retirement savings under certain conditions.

Specifically, it illustrates the importance of diversification, as well as the need for employees to have appropriate investment education, appropriate investment advice, and greater disclosure. All of these may help them to better navigate the risk they face in saving for retirement.

In addition to the broad issues of diversification, education and advice, Enron's collapse raises questions about the relationship between various plan designs and participant benefit security.

In particular, Congress may wish to consider whether further restrictions on floor offset arrangements are warranted, whether to provide additional employee flexibility in connection with matches in the form of employer stock, and whether to limit the amount of employer stock that can be held in certain types of retirement savings plans.

Resolving these issues will require considering the trade-offs between greater participant protections and the employer's need for flexibility in plan design.

Finally, Congress will have to weigh whether to rely on the broad fiduciary standards established under ERISA that currently govern fiduciary actions or impose specific requirements that would govern certain plan administrative operations such as plan investment freezes or lock-downs.

Again, Mr. Chairman, in addressing these issues it will be critically important to balance the need to provide employers with reasonable flexibility with regard to plan design and funding decisions, at the same time making sure that there are adequate safeguards to protect the retirement security of plan participants and beneficiaries.

I would be more than happy to answer any questions that you and the other Senators may have.

[The prepared statement of Mr. Walker appears in the appendix.]

The CHAIRMAN. Well, I appreciate that, Mr. Walker.

Let us kind of take each of the subjects. One, is out in the news, namely the suggestion that there should be caps on the percentage of company stock in a 401(k) plan. Could you just talk about that for a while, please? Just give us your thoughts of what is best for the investors, that is, the employees' point of view, first.

Mr. WALKER. We have to recognize that there are several different types of plans. On the one hand, you have an ESOP which could be a freestanding employee stock ownership plan, which is designed to invest primarily in employer securities. By law, that would mean 50 percent plus one dollar at a minimum, but practically they invest a lot more.

They are designed to achieve a number objectives. So they, by design, when they are freestanding, are intended to accomplish a number of objectives that are above and beyond retirement savings.

However, when you have an ESOP that is affiliated with a 401(k) plan, a so-called KSOP, it raises a range of other issues. For example, quite frequently employers will end up creating ESOPs as a means of satisfying the employer match. As you know, Mr. Chairman, employers are not required to match employee contributions. That is discretionary.

As a result, to the extent that they decide to match employee to contributions, which is something that I think is positive, many employers may want to use employer stock as a way to make that match, for a variety of reasons. Many employers require individuals who receive that match to keep it invested in employer stock for an extended period of time.

Employers may also have a 401(k) plan that allows for investment in employer securities, along with other forms of investment. In the case of Enron, you had a situation where you had the match in employer stock, and you also had employees who voluntarily decided to invest a large part of their own savings in employer stock, and we all know what ended up happening.

My personal view, Mr. Chairman, is that you may want to consider separating traditional ESOPs from ESOPs that are related to 401(k) plans. In addition to that, you may want to think about differences between the match, which you want to encourage employers to provide, and the amounts that employees save voluntarily.

The great debate, I think, will be: should you provide more flexibility to allow employees to diversify out of employer stock, including the match, quicker than they are currently allowed under current law? or, do you set limits on how much employer stock they can have? Either one is going to create plan administration challenges, significant plan administration challenges.

Participants may tell you they would rather have the choice. As long as they have adequate disclosure, as long as they have adequate education, as long as they have adequate plan investment advice, they might rather have the flexibility and the choice than to have a limit imposed. I think that is something that is going to have to be adequately debated.

The CHAIRMAN. It certainly will. And I do not mean to press you too much personally, because that is really not your job, but you still have a lot of experience in this area. So, what are the param-

eters, the highs and lows, by which we might define the boundaries of flexibility versus protection?

Mr. WALKER. In my personal view, I would focus on the use of KSOPs, 401(k) plans in conjunction with ESOPs. One area that may bear consideration is whether or not employees ought to have the ability to divest, or dis-invest, in employer securities quicker than they currently have under current law with regard to those employer matches.

I think another area that this committee may want to consider is whether or not employees should be able to invest their own money in employer stock under a 401(k) plan if the match is exclusively in the form of employer securities.

Let me give you an example of that, Mr. Chairman. A typical 401(k) plan for a major employer will say, I am going to match 50 cents for every dollar you contribute, up to a cap, let us say 6 percent of compensation.

So typically, if that is the case, then it means by definition that one-third of the employee's investment, assuming no changes in stock prices and other market values, will by definition be in employer stock.

It will be one-third, subject to market fluctuations, unless and until individuals are given an opportunity to diversify out of employer stock. The problem can be compounded when employees are allowed to invest in employer stock with regard to their own savings.

That is what happened at Enron. That is how you got to the situation where over 80 percent of the plan investments were in employer stock. It was a combination of the match, as well as employees voluntarily deciding to invest some of their own money in Enron stock.

The CHAIRMAN. Thank you. My time has expired.

Senator Grassley?

Senator GRASSLEY. I only have two questions. The first one, I want you to answer in writing as opposed to speaking out, because presumably I want a definitive list and I want it to be an accurate list. I would like to have you enumerate what studies you and your agency have accepted and are undertaking Congress-wide regarding Enron, whether they pertain to retirement plans, executive compensation, compensation, or issues of auditing.

Mr. WALKER. I would be happy to do that.

Senator GRASSLEY. Yes. Thank you.

Now, in regard to a decision you may have possibly been involved in when you were either at Department of Labor or the PBGC, and I do not know which it was, but it involves the floor offset arrangements and when they were grandfathered.

Do you recall what position you took with regard to the floor offset plans at that time? Was the Department of Labor for or against permitting floor offset ESOPs? The idea here is, I really would like to know your role in that decision making.

Mr. WALKER. Thank you for asking the question, Senator. I think it is instructive here. I do recall very clearly. I was at the Department of Labor. In my view, it was inappropriate to allow floor offset arrangements. What they represented was an attempt to achieve indirectly what you could not achieve directly.

Namely, through affiliating a defined contribution plan that was invested heavily in employer securities and relating that to a defined benefit plan promise, they effectively allowed employers to have more than 10 percent of a defined benefit promise backed by employer stock, which proposed, I believe, a risk to the retirement security of plan participants and beneficiaries, as well as a risk to the pension insurance system.

I personally recommended, and the administration adopted, the repeal of floor offset arrangements, recognizing that when the legislation was considered there might be some desire to have a phase-out of floor offset arrangements.

But I personally felt very strongly, as did the administration, as I recall, that floor offsets should not be grandfathered because of the risk. Nonetheless, they were grandfathered when the actual legislation was enacted.

I would note for the record, they are still grandfathered. I think one of the things that the Senate, this committee, and the Congress should consider is whether or not they should continue to be grandfathered.

Furthermore, I would note for the record that Enron voluntarily phased out of their floor offset arrangement, but other companies have not. I do not know how many of these still exist. I think it would be a great project for the Labor Department, to determine how many of these still exist, and to what extent there may be other exposures out there.

Senator GRASSLEY. Thank you very much for your thorough answer.

Mr. WALKER. Thank you for asking that question.

Senator GRASSLEY. Mr. Chairman, I am done.

The CHAIRMAN. Thank you.

Senator Bingaman?

Senator BINGAMAN. Thank you very much.

Mr. Walker, thank you for your excellent testimony.

I wanted to ask about the issue of investment advice. I am sponsoring a bill with Senator Collins called the Independent Investment Advice Act of 2001. It is one of many bills, as I think was referred to in your testimony and by the Chairman, related to some of these issues.

But the thrust of that bill is to ensure that, from my understanding of current law, if an employer does make available an investment advisor to his or her employees, that there is a possibility, at least, that the employer might wind up being somewhat liable for bad advice and for decisions made on the basis of bad advice, so that most employers shy away from providing any kind of investment advice in order to shield themselves from that liability.

What we have done in our bill, is to essentially create in law a safe harbor of sorts by saying, as long as the person who is being provided to the employee as an investment advisor is, in fact, qualified and independent and meets certain criteria, then the employer is not liable if the advice turns out to be wrong.

What we have proposed is very different, as I understand it, from the administration's proposal. The administration's proposal on this issue does not have that requirement in there that the investment advisor that is provided by the employer be independent, in the

sense that the investment advisor can have investment products that they are selling.

For example, you can bring in a mutual fund company to provide investment advice to your employees and they can provide the advice, and at the same time try to sell them, or certainly be in the position to sell them, certain investment products.

That seems to me to create a conflict of interest between the advisor and the employee that is not in current law. It has been my thought that that would be a step backward for us to essentially write into law, as the administration proposal seems to do if I am reading it right, this opportunity for conflict where none exists today.

Do you have a thought on this?

Mr. WALKER. I do. The key word you used was "independent." If you are independent, and therefore you do not have a potential conflict or you do not have a vested interest in whatever the participant does, then obviously the safeguards do not need to be as numerous as when there is a potential conflict.

Let us say you have Mutual Fund X. I will not mention any names. Mutual Fund X is actually providing the different investment options that are being provided under the plan. Mutual Fund X also wants to provide investment advice, and therefore there could be a conflicting interest or a conflict of interest.

I think the key is, if you are going to allow those kinds of circumstances, you need to make sure that there are adequate protections, safeguards, and oversight to assure, in design and in actuality, that the party cannot do anything that would serve to increase their fees. So, to a great extent it would depend upon how this service would be designed.

If, for example, you had a circumstance where you had different investment options with no transaction fees involved, and where the amount that the investment manager would get paid would be the same for every investment fund option and they had all the investment options under the plan, then you could theoretically prevent a conflict in that circumstance.

But I think if the party who is offering the investment options is not independent from the party who is providing the advice, then there need to be adequate safeguards and protections to make sure that the advisers are not in a position to increase their own fees, either directly or indirectly.

Senator BINGAMAN. At an earlier hearing we had, Secretary of Labor Chow's statement was, I think, that they felt that safeguards would be there, in that anyone would a conflict would have to disclose that conflict. That does not give me the warm, comforting feeling that I would like to have about this, just the requirement that people have to disclose a conflict. It seems to me we ought to try to build in something where there is no conflict.

Mr. WALKER. May I respond to that, Senator?

Senator BINGAMAN. Yes, please.

Mr. WALKER. I do not know all the details, and obviously I would need to know the details. I will say this. In dealing with conflicts and independence issues, the SEC's experience is longstanding. I am not saying that should govern here, but they believe strongly that you cannot solve a conflict through disclosure. The Labor De-

partment has generally taken the same position in connection with the fiduciary provisions of ERISA.

In addition, let us take the current situation with regard to auditors. Is the answer merely to disclose the conflict and you are all right? I would question that.

So, I think disclosure may be one element of a safeguard, but disclosure, in and of itself, I do not believe gets the job done.

Senator BINGAMAN. Thanks very much.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. Thank you and Senator Grassley very much for having this hearing, which I think is very, very important. I mean, if nothing else good comes out of the Enron debacle, it is going to be that the American people have a great deal of knowledge about their own pension plans than they probably have had before. They are going to start paying attention to how their pension plans are being invested, and what the requirements are as to where they are going to be invested.

While some may think that this hearing is rather dull and esoteric, no fault of Mr. Walker, I actually think probably more good can result from this type of hearing than some of the more headline-grabbing hearings that we have had.

I spent yesterday morning in another committee, the Commerce Committee, listening to Jeff Skilling say nothing. You do not say anything, it is kind of hard to find something we ought to do as a result of it.

I think what we have here is really the nitty-gritty of trying to make sure that another Enron does not happen. It is really kind of a question of whether it was bad people, or maybe bad laws. I am not sure.

Maybe it was a combination of bad people taking advantage of bad laws. Our job is going to be to change the bad laws and make it more difficult for bad people to get around them, if in fact that was what the case was.

Let me ask one question about publicly-held companies versus privately-held companies vis-a-vis their pensions and having ownership in the companies.

Publicly-held companies, obviously, would have access to the public capital markets, and privately-held companies would not have that same advantage. There are proposals to change the current law regarding the ability of employees to diversify out of the non-publicly traded company stock, or perhaps impose limits on how much they can own of the non-publicly traded stock. It would seem to me that that has a great potential to harm the privately-held companies versus the publicly-held corporations.

Do you understand what I am talking about?

Mr. WALKER. I do, Senator. But under ERISA, and I do not practice ERISA every day now like I used to, but in general the only kind of stock that can be held by a qualified pension or savings plan, are deemed to be qualifying employer securities. Generally they must be publicly-traded securities or convertible into publicly-traded securities. There are, however, certain exceptions for ESOPs in closely held companies.

Under ERISA, a pension plan generally is prohibited from holding an employer security which does not meet the definition of "qualifying employer security." "Qualifying employer security" is defined under Title 1 of ERISA, section 407(d)(5), (29 U.S.C. § 1107(d)(5)), as: (a) stock, (b) a marketable obligation, which means a bond, debenture, note or certificate or other evidence of indebtedness meeting certain conditions, or (c) an interest in a publicly traded partnership as defined in the Internal Revenue Code (the Code), but only if such partnership is an existing partnership as further defined in the Code. In order to qualify as stock, section 407(f) of ERISA provides that a plan may not acquire more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class. This section also provides that at least 50 percent of the issued and outstanding stock must be held by persons independent of the issuer.

With respect to an Employee Stock Ownership Plan (ESOP), "employer securities" under section 409(l) of the Code are defined as: (a) common stock issued by the employer (or by a corporation which is a member of the same controlled group), which is readily tradable on an established securities market, (b) if there is no readily tradable common stock, then common stock issued by the employer (or by a corporation which is a member of the same controlled group) which has a combination of voting power and dividend rights equal to or in excess of (1) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (2) that class of common stock of the employer (or any other such corporation) having the greatest dividend rights; and (c) certain noncallable preferred stock if such stock is convertible at any time into stock which otherwise meets the requirements above and if the conversion is at a conversion price which is reasonable.

Mr. WALKER. But I think there is already a differentiation that is noted under current law with regard to qualified plans.

Senator BREAUX. Well, am I wrong in saying that if I had a stock, an ESOP plan in a privately-held company and we had these restrictions on the amount of stock I could have in the company I work for that is a privately-held company, you do not think that creates a problem?

I am just concerned that if the privately-held company has to buy back that stock, the only people that can buy it back is that company. They cannot go to the public to do it.

Mr. WALKER. That is what traditional ESOPs in closely-held companies do, is have the put option to the employer.

Senator BREAUX. Right.

Mr. WALKER. Yes. I think what this committee needs to be careful about is to recognize that there are a lot of different types of plans. You have ESOPs, some of which are dealing with big public companies, some of which are dealing with smaller, more closely held companies. You also have circumstances where you have freestanding ESOPs by themselves, which are designed to achieve a number of objectives. You have the use of ESOPs in conjunction with 401(k) plans, which raises a whole range of other issues.

Then you have circumstances where the stock is being used for the match, which you want to encourage, versus where employees

have an option to be able to invest in stock, which caused you to get to the situation you had in Enron where you had over 83 percent of all the plan's investment in the form of stock. So, I do think you need to be sensitive to some of the differences you are talking about.

Senator BREAUX. All right. Getting back to my initial comment about bad laws versus bad people. I take it—and I do not want to put words in your mouth—but do you think that the floor offset arrangement is bad law?

Mr. WALKER. My personal view, Senator—and this is going back to when I was Assistant Secretary of Labor for ERISA in 1987—that the floor offset arrangement allows sponsors to do something indirectly that they cannot do directly. That was the position of the Reagan administration in 1987 when I was Assistant Secretary. I can understand if the Congress decides that it might want to provide a phase-out. I can understand that. Or allow people to decouple over a period of time. Frankly, that is what Enron did, believe it or not. Enron could have kept the floor offset arrangement forever, but they voluntarily decided to wind down their floor offset arrangement. But there are others out there who have not done that.

Senator BREAUX. One final question. Do you have any idea how many are out there still? You did not know the names. I guess the Labor Department would have that.

Mr. WALKER. Well, Senator, let me mention one of the biggest frustrations that I have. We are about ready to issue a report with regard to the Pension Welfare Benefits Administration. One of the things I recently found out, is that the most recent data they have is 1997, which is incredible to me.

Senator BREAUX. Oh, wow.

Mr. WALKER. But, nonetheless, evidently true. I think 1998 is getting ready to come on-stream here shortly, but this is 2002!

Senator BREAUX. Yes.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you very much.

Mr. Walker, one of the administration's proposals was to have a new fiduciary responsibility to create liability, I guess, if there is a loss during a black-out period. I have some reservations about that. I used to be a fiduciary of a pension plan.

Correct me if I am wrong, but I can easily see a scenario where an administrator or a fiduciary wants to make a plan change or change in their administrator, which would incur a black-out period, but if they are threatened with potential liability, they may not want to make that change.

In other words, they may be stuck with inept administration. They may forego consolidation of plans. They may forego an improvement of the plans because they do not want to be liable, in a volatile period, of potential losses.

So, I understand the desirability, some people say, well, we think somebody should be liable. Granted, it is the participant in a 401(k), if they control the investments prior to the black-out period. But to say during the black-out period the employer or the fidu-

ciary of the plan will be responsible, I think, would discourage black-out periods, and that may not be in the long-term interest of the plan participants.

I mention that. Have you thought of that?

Mr. WALKER. Yes.

Senator NICKLES. Am I unique in raising that issue?

Mr. WALKER. I know you have been a fiduciary before, and so have I. There are difficult issues here. I mean, on one hand I think we have to keep in mind that, under ERISA, the prudence standard overrides everything.

So one of the things that presumably plan fiduciaries would consider is, even in connection with plan freezes, or lock-outs, or whatever you want to refer to them as, based upon the individual facts and circumstances, including the volatility of the stock and condition of the company, whether it is prudent to have a plan freeze at that particular time?

That is going to be something I think fiduciaries need to consider based on facts and circumstances. But in the vast majority of cases, that is not going to be a problem. When you change administrators, the fact of the matter is, you need to have a freeze in order to make it work.

So I think one of the things that needs to be worked through, is what can you to do try to make sure that you recognize reality, that people are going to change plan administrators, people are going to change plan investment options, and that they might have to end up doing certain things in order to effectuate those decisions.

So, you should not put undue restrictions on that at the same point in time that somebody is freezing something, at a time where it is fundamentally imprudent to do that based upon, let us say, the volatility of the stock or the circumstances with regard to the employer at that point in time. That might well be a different circumstance, and I do not know that you need a change in law to address that.

One of the things the administration is talking about—and Senator Nickles, you may want to ask them—is this whole issue of ERISA section 404(c). It says that employers are relieved from certain fiduciary liability and responsibility if they design and operate their plans in certain ways.

The one question that gets raised is, well, if they are not providing investment choice during a period of time, do they lose 404(c) protection? This is, I think, what you are basically saying. Do you lose it? Therefore, if you lose it, are you going to end up causing problems in 100 percent of the cases when you really ought to be focusing on those circumstances where it just may not be prudent to do it at that point in time?

Senator NICKLES. Well, I am concerned about it. I can easily see, if fiduciaries see an added liability during a freezer period, they may say, well, I think maybe we should change.

I think there is a better proposal, it is more economical, or here is a better track record by a different administrator and I would like to make that change. But, if I do so, I may have a lot of liability and I am not sure I want to risk that, and therefore not make the change.

I just have serious reservations about that one particular provision. I can see the appeal of it, but I think maybe it is short-sighted.

Mr. WALKER. I think you have a legitimate concern.

Senator NICKLES. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

Mr. Walker, as is evident from my seat here at the end of the row, I am the last man on the totem pole. You have obviously spent your life in the details of many of these matters, so I will just present mine in layman's terms.

But earlier you spoke of the concentration of the employer stock in the employee retirement plans, and certainly by the very nature of the company match being the employer stock, the employee would certainly likely end up with a substantial amount of the company stock in their plan.

You also hinted that maybe employees should be limited in these circumstances as to the type of investment that they could make. I am wondering whether there are other policies that we should address that would potentially lead to concentration of employer stock, and would there be other alternatives other than just limiting them?

Basically, what is the policy argument for making the payment of dividends to the shares of the 401(k) plan tax deductible to the company?

Mr. WALKER. Those are a lot of issues.

First, again, I would say, Senator Lincoln, that I would respectfully suggest that the committee may want to think about free-standing ESOPs that are not being handled in conjunction with 401(k) plans separately. Obviously, one of the tax benefits accorded to an ESOP is to be able to use dividends in a tax-favored fashion. That is one thing.

In the case of Enron and many other employers, you have a circumstance where there is an ESOP that is used in conjunction with a 401(k) plan.

Senator LINCOLN. But still separate.

Mr. WALKER. Well, it is a separate feature. But basically the ESOP is used to make the employer match. We want to encourage employers to do matches, I would argue. They like to do it in the form of stock, for a variety of accounting reasons, economic reasons, and tying employees' interests to the shareholders', and to the company's interest, and other reasons.

My personal view is, you may want to think about whether or not there should be additional flexibility accorded to employees to diversify out of that stock quicker than they can right now when it is in conjunction with a 401(k) plan, or whether or not you may want to think about placing certain restrictions on the ability of either employers to offer, or individuals to have, their own money invested in employer stock under a 401(k) plan.

That is how you got to the situation at Enron, where, by definition, at least a third of it was going to be in employer stock because

of the match. That is not necessarily bad. You want employers to give matches.

On the other hand, that, combined with employees investing in it, if that is the only type of retirement plan you have, then you are really betting the ranch on the company.

Senator LINCOLN. You alluded to that, I think, earlier. I just did not know if there might be other policy ideas that you had in terms of just limiting what employees could do.

Mr. WALKER. The difficulty is, if you were to say, for example, employees should not invest more than 20 percent in employer stock, obviously, a lot of employees are not going to like that.

In addition, you are going to have major plan administration problems. When do you determine that 20 percent? Is it every day? Is it once a year? Stock prices change constantly. So, there are major plan administration problems associated with that.

That is why one easier way to do it would be to say, if the match is going to be in employer securities, employees should be able to diversify out of that match quicker than they can right now, so give them choice, combined with more education, combined with additional flexibility for investment advice.

Then think separately about whether or not you want employers to encourage employees to invest in employer stock if they are doing the entire match in employer stock. Do you want to encourage that? I mean, is that something you want to allow? That is where you can end up getting huge concentrations in employer stock.

I think it might make a difference, too, if this is the only retirement plan that is being offered versus if there are defined benefit plans being offered, and certain other things being offered.

Senator LINCOLN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Next on the list, I have Senator Thomas.

Senator THOMAS. I am sorry I was not here, Mr. Chairman.

Let me just ask a general question. Given the Enron situation, with thousands of plans, how much impact does what happened with Enron have to do with the general retirement program?

Mr. WALKER. I think there are certain aspects of the pension savings system that Enron serves to bring light to, and that should cause this committee and Congress to rethink certain things, one of which I would give as an example: the floor offset arrangements.

Should employers be able to have defined benefit promises that individuals are counting on, that are guaranteed by the Pension Benefit Guaranty Corporation, and should they be able to use defined contribution plans that are invested heavily in stock as a way to try to satisfy some of the funding requirements for the defined benefit plan? Should you be able to do that?

Second, what, if any, additional flexibility should individuals have who are in 401(k) plans? When the company decides to match their contribution in employer stock, what, if any, additional flexibility should employees be able to have to divest out of that stock into other investments if they so desire, quicker than they are allowed to do under current law?

What, if any, restrictions should be placed, or conditions should be placed, on plan freezes or lock-downs, or do the current fiduciary

rules adequately cover it? Should executives be able to exercise stock options during a plan freeze, where you create an unbalanced playing field? Now, that is not an ERISA issue. That is a different issue. That would not be the pension laws, that would be something else. And there are a few other issues, I think, in the testimony that might be helpful in this area.

Senator THOMAS. Would you have thought about those prior to Enron?

Mr. WALKER. Well, some of these I did think about prior to Enron, because when I was Assistant Secretary of Labor in 1987, during the Reagan administration, of which I was a part at that point in time, recommended banning floor offset plans.

What happened was, when the law was passed, no more were allowed, which was positive, but the existing ones were grandfathered. So I think one of the things you want to look at, is do you want to think about phasing those out?

Interestingly, Enron phased theirs out voluntarily, but there are other ones out there that have not done this.

Senator THOMAS. Thank you, sir.

Mr. WALKER. Thank you, Senator.

The CHAIRMAN. I would like to just know, generally, where you think the biggest problems lie. Now, you mentioned a good recitation of some of the areas we have to look at. The corresponding question is, where are you a bit concerned that Congress might act and create some harm, most likely?

So, you mentioned divestiture, lock-outs, and offsets, and so forth. Maybe we have to address all those issues, and we certainly do have to address all those issues, but I am just wondering if there is an area that you think, generally, looking out in the country, that we have to spend more time on.

Then on the other hand, where are you concerned that, oh, my gosh, Congress might go off in this area and that could cause more problems than it is going to solve?

Mr. WALKER. Well, I would say the floor offset is an area. There may not be a whole lot more out there, and the Department of Labor ought to be able to tell you that, hopefully. But no matter how many there are, they could represent huge risks depending on individual facts and circumstances.

I would say the area of whether or not participants ought to have additional flexibility to diversify out of employer securities, that is something you may want to take a look at, especially in circumstances where the only plan that the employer provides for retirement is a plan that, by definition, is designed to invest heavily in employer securities. I am talking about plans, other than freestanding ESOPs, which are supplemental to other types of plans.

I would say that, no matter what you decide to do, you should ask first, what does this proposal do from the standpoint of encouraging—or discouraging, I should say—employers to create, maintain, or properly fund these plans?

Second, what is the administrative feasibility of what you are proposing to do? There are certain things that sound good on the surface, but on the other hand, how difficult will it be to actually make it happen in practice?

Senator Nickles talked about plan administration. I mentioned before that if you say you cannot invest more than X percent in employer stock, well, that measure changes every day. I mean, there are practical problems in doing that.

Freezes. You have got to have freezes in order to make certain things happen. On the other hand, I would say that under current law there are circumstances where fiduciaries could be sued if it was fundamentally imprudent to have a freeze at that particular point in time based on individual facts and circumstances. That would be a more targeted approach rather than potentially creating a problem that could affect every freeze that might ever exist.

The CHAIRMAN. What about executive sales of the company stock during a lock-down? Enron.

Mr. WALKER. You may wish to consider, as a matter of equity and as a matter of fairness, whether or not executives ought to be able to exercise their stock options or otherwise trade during lockdowns. Of course, those amounts are not in qualified plans. They are amounts that otherwise are just outside of qualified plans.

The CHAIRMAN. Right.

Mr. WALKER. You may want to decide whether or not that is appropriate and equitable. But, again, that would not be an amendment to ERISA. It would be related to what would happen under ERISA, but it would be separate.

The CHAIRMAN. Correct. Correct. Well, thank you very much.

Senator Snowe, do you have questions?

Senator SNOWE. Yes, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator SNOWE. Thank you, Mr. Chairman.

Mr. Walker, could you speak to the diversification requirements in a pension plan? That is one of the issues that Senator Kerry and I are looking at in terms of legislative changes and requiring some diversification for employees' pension plans, either in 401(k)s or in ESOPs.

Mr. WALKER. Well, first, by definition, under current law, ESOPs are required to be invested primarily in employer securities, which means at least 50 percent plus one dollar. From a practical standpoint, they are invested a lot more than that in employer securities, in part because of what they are designed to achieve.

As you know, Senator Snowe, they are not designed solely to be retirement plans. In fact, I would argue they are not the optimum type of retirement plan. They are designed to achieve other objectives, for example, to try to correlate the employees' interests with the company's interest; to try to correlate the employees' interests to the shareholders' interests; to try to encourage productivity, innovation, and other types of things; and to broaden ownership, and for a variety of other reasons.

I do think that in most plans there is a diversification requirement. The exceptions are ESOPs and certain types of participant-directed plans where the participants have the choice as to how they invest, and if certain conditions are met.

In those circumstances, if the participant decides that they do not want to diversify they do not have to diversify, as long as they are provided an adequate number of choices, an adequate number

of opportunities to move their money periodically, and as long as they are provided adequate information.

So, part of that debate would be whehter you want to be more paternalistic or not? Do you want to tell participants that we are going to put some hard limits on what you can do, or do you want to focus more on providing them additional flexibility, making sure that there is an emphasis on more education, looking to see whether or not they could be provided more professional investment advice where there is not a conflict of interest?

If you place limits, I think you have to think about, how do you make that happen operationally? Because stock prices change every day. Every day, stock prices are changing. So if you set a limit, do you do it once a year in order to make it administratively feasible, or what?

Senator SNOWE. Well, do you think that it would be worthwhile to allow for diversification after so many years of service? I mean, that is obviously one of the things that we are looking at, maybe diversification after 3 years of service.

Mr. WALKER. I think trying to tie it to years of service has merit.

Senator SNOWE. And age.

Mr. WALKER. Right.

Senator SNOWE. Yes.

Mr. WALKER. It has merit because employers may not make as many matching contributions in the form of employer stock if you tell them that, on day one, you have got to move the money out of employer stock.

So from a practical standpoint, there needs to be some period of time when employees can invest in that stock or else they may not make the contribution to begin with, and that is not something you want.

So to the extent that you try to link it to maybe age and/or years of service, and to get it to where it does not have to be done on a daily basis, where maybe it is done once a year, where you can make it feasible from a plan administration standpoint, that would be important.

Senator SNOWE. And in response to what occurred with Enron, what do you think are the major issues that we ought to focus on with respect to changes in pension law?

Mr. WALKER. Well, I would look at the floor offset arrangements. I would look at the issue of whether or not participants ought to have additional flexibility to be able to diversify out of employer securities.

I would look at what, if anything, needs to be done in order to provide people with the ability to make sure that participants get qualified investment advice, either from independent parties, or if the parties are not independent, with sufficient safeguards to avoid conflicts of interest in reality rather than just the potential for conflicts of interest. Those would be a few, off the top of my head.

Senator SNOWE. And on black-out periods, again, as we saw during the whole Enron event, where the employees were denied the ability during that black-out period because, ostensibly, there was a change in administrators, is that common practice, number one?

Second, would it also apply to the top officials in a company?

Mr. WALKER. It is common practice that, when you end up changing plan administrators, investment options or service providers, the restrictions apply just to whoever has stock in the plan, whether they be executives or non-executives.

What happened in the Enron situation, was you had a number of executives who were exercising stock options or had the ability to exercise stock options that were outside of the plan during the time when participants in the plan, including the executives if they were participants in the plan, could not sell their company stock in the 401(k) plan.

Senator SNOWE. All right. Thank you very much.

Mr. WALKER. You are welcome.

Senator SNOWE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

I have forgotten what you said in an earlier book, Mr. Walker, but it is something to the effect that you thought investors were too conservative, or you wanted them to be a little more aggressive.

Mr. WALKER. Well, no, I do not think I said that. But what I did say, is——

The CHAIRMAN. Were these pension holders not pretty aggressive?

Mr. WALKER. I would say it varies by individual. But in the case of what happened in Enron, it was clearly a violation of one of the fundamental tenets of investment, and that is the tenet of diversification. You should not put all your eggs in one basket. You could end up doing extremely well or you could end up being left with nothing.

Basic fiduciary prudence tells you, as well as ERISA's fiduciary requirements and professional money managers experience, to engage in diversification not only because the law requires it in certain circumstances, but because that is the appropriate thing to do in order to manage relative risk.

The CHAIRMAN. What do you tell all of those big blue chip companies where a much higher percentage than in Enron's case of the company stock is held in 401(k)s? What do you tell those folks who work for big blue chip companies. I think I saw a table somewhere, that it is 80 percent, up to 90 percent.

Mr. WALKER. Yes. It is hard to get much higher than Enron was. It is possible, but they were well over 80 percent. I do not recall the exact number. It obviously depends upon which point in time you are talking about, too.

Obviously it would have been highest when the stock price was very high. When the stock went into the tank, then obviously the percentages changed very dramatically, and very quickly.

I think what you have to do is think about going forward. What is the proper balance between encouraging employers to make matches, and encouraging employers to create and maintain plans while having reasonable safeguards for participants?

I do think one of the things you may want to look at, which I know the administration has talked about, is rather than an absolute cap on the amount that employees can have, additional flexibility to allow them to diversify out much quicker than they can right now, coupled with a variety of other actions dealing with education and advice to try to help minimize the possibility that this

type of situation will recur. It will not eliminate the possibility, but it sure would help.

The CHAIRMAN. Senator Breaux, do you have any further questions?

Senator BREAUX. Just on that point, David. I do not understand. Is there a difference between the managers of a pension plan giving advice on investing in the company's stock in their pension versus the officers of a company making those recommendations?

If the manager of the plan cannot make those investment recommendations to individuals, as I understand it under ERISA, the plan managers cannot do that, can the officers of the company stand up at a stockholders meeting and say, all of you ought to put all the money you possibly can into Enron, or any company, because we are going to do great in the next 6 months?

Mr. WALKER. Off the top of my head, Senator, I would say unless they are a plan fiduciary——

Senator BREAUX. They can do that.

Mr. WALKER. All right. They can do that.

Senator BREAUX. Is that a problem? I mean, it seems to me that if I am an employee just doing my daily work at a company that makes widgets, and whether it is the fiduciary of the pension plan telling me to invest all my assets in the company stock or just the president of a company, it is not much difference in the effect that it is going to have on me.

I would probably be more affected if the president of the company is telling me to do it. He apparently can do that, but the manager of the plan cannot. I mean, should they all be under the same restrictions, making those kind of investment recommendations?

Mr. WALKER. Sometimes officers will also be plan fiduciaries and they will wear two hats. The plan fiduciaries who are deciding what the investment options are under the plan retain fiduciary responsibility for whether or not those investment options are prudent.

Presumably, if you had a circumstance where you had somebody out there doing something that, on its face, was clearly imprudent, whoever the plan fiduciaries were would have a responsibility for determining whether or not some action should be taken.

Senator BREAUX. Well, I will tell you, you run across a real rubicon there when the officers and directors are telling the employees to invest in the stock, while the officers and directors themselves are bailing out as fast as they can.

Mr. WALKER. Yes. That might be an issue as to whether or not you want to think about requiring additional disclosure or providing additional restrictions in circumstances that are not currently addressed under ERISA because those officers were not fiduciaries.

Senator BREAUX. The simple, honest answer to the employee's question is: Mr. President, what are you doing with your stock? I want to do the same thing. All right. I appreciate it. Thanks.

The CHAIRMAN. Any other questions, Senator Snowe, Senator Grassley?

Senator SNOWE. No.

The CHAIRMAN. One minor question, maybe not so minor. As we have moved from defined benefit to contribution to some degree in

this country, and you get greater rewards but you have greater risks, has anyone given thought to some kind of a defined contribution plan insurance, some way to hedge?

Mr. WALKER. The difficulty is, as you know, the fundamental difference between the defined benefit plan and the defined contribution plan, among other things, is in defined contribution plans the participant bears the investment risk.

The CHAIRMAN. Right.

Mr. WALKER. If anybody is going to insure those types of plans, whether it be the government or anybody else, you are going to need some ability to control the related risk.

Right now, I would argue that you might have a tough time finding somebody who would end up insuring a plan that was invested 83 percent in one stock. And whether or not the government insure something that is invested 83 percent in one stock, I would question.

I do think that there are some major issues that this committee may want to address, in that the composition of plans that we now have in our country is fundamentally different from what we had 20 years ago. We used to have primarily defined benefit plans, but now we are primarily defined contribution plans. There are pros and cons to that. Also, a vast majority of defined contribution plans allow participants to decide how they are going to invest their money. Most participants are not sophisticated investors. Most need education assistance and, potentially, advice to try to help them make informed judgments. So, I am happy to help you in any way possible.

If I can, Mr. Chairman, I want to clarify one thing. ESOPs can invest in certain non-readily tradable stock. So when we talked before about the issue, certain kinds of plans only can invest in publicly traded stock. There are certain exceptions for ESOPs sponsored by closely-held companies employee stock ownership plans.

That is why I am saying I am happy to meet with you or any of these members privately to talk about some of the details because it is a very complicated subject and my staff and I will be available to you.

Senator BREAUX. If you do that, will that be on the record? [Laughter.]

Mr. WALKER. I will be happy to report who met with whom, when, about what, if there is any correlation to anything else going on.

The CHAIRMAN. Well, on that note, Mr. Walker, you have done a great job here and you perform a great service to our country. We thank you very much for your service.

Mr. WALKER. Thank you, Mr. Chairman.

The CHAIRMAN. In the interest of time, I am going to break precedent here and ask the next two panels to come up together. This is a bit of a break, but we are going to go ahead anyway.

The panel consists of Mr. William Sweetnam, Jr., who is the Benefits Tax Counsel for Department of Treasury; Mr. Steve Kandarian, Executive Director with the Pension Benefit Guaranty Corporation; Dr. Jack VanDerhei, Temple University, and also research director of the Employee Benefit Research Institute; and Mr. Bradford Huss, with Trucker Huss in San Francisco.

We will begin with you, Mr. Sweetnam, and thank you very much for agreeing to be seated together. We appreciate it very much.

Again, all statements will be included in the record.

STATEMENT OF WILLIAM F. SWEETNAM, JR., BENEFITS TAX COUNSEL, DEPARTMENT OF TREASURY, WASHINGTON, DC

Mr. SWEETNAM. Mr. Chairman, Senator Grassley, and distinguished members of this committee, thank you for inviting me to appear before the Finance Committee.

As you are aware, certain recent events such as the loss of substantial workers' retirement savings due to failures of well-established businesses have prompted a critical examination of employer-provided retirement plans.

This has raised legitimate concerns that merit close attention and thoughtful solutions. I applaud the Chairman for calling this hearing.

At the outset, we must recognize that the issues relating to promoting and protecting retirement savings can be difficult, and the proper balances hard to strike. Under our retirement system, no employer is obligated to provide a retirement plan for employees. The private retirement system is completely voluntary.

There are clear benefits to employers who provide retirement plans, not only tax benefits, but also the benefits of hiring and retaining qualified employees who help the businesses prosper.

Because of these benefits, we must be careful not to over-burden the system. If costs and complexities of sponsoring a plan begin to outweigh advantages, employers will stop sponsoring plans. On the other hand, we must do what we can to ensure that workers have adequate protections and information to make informed choices.

I want to make a point that this committee last year, in enacting EGTRRA, made some significant steps in trying to advance retirement plan sponsorship and also advance protections and things that would be helpful to employees. So, I applaud the committee.

This pursuit of policies that make private pension plans available to a greater number of workers and that provide individuals with the freedom to plan for their own retirements has clearly been justified. But just as the 42 million 401(k) participants carry more and more responsibility, full confidence in the security of their pension plans is essential.

Too many of the workers lack adequate access to investment advice and useful information on the status of their retirement savings. Moreover, better advice and information serve little purpose unless workers are free to act on them, at least to the same extent as the executives for whom they work.

In this mind, the President has put forth a balanced, four-step proposal based on the recommendations of the Retirement Security Task Force. The President believes that Federal retirement policy should expand, not limit, employee ability to invest plan contributions as they see fit.

First, the President's proposal would increase workers' abilities to diversify their retirement savings. While many companies already allow rapid diversification, others impose holding periods that can last for decades. The President's proposal provides that

workers can sell company stock and diversify into other investment options after they have participated in the 401(k) plan for three years.

Second, the President's proposal addresses the concerns regarding black-out periods, periods where plan participants are restricted from selling shares. The President has proposed policies that create equity between senior executives and rank-and-file workers by preventing executives from selling stock during times when workers are unable to trade in their 401(k) plans.

As a matter of principle, the interests of the executive officers and rank-and-file employees in a company should be aligned. The proposal also clarifies that employers have fiduciary responsibility for workers' investments during a black-out period.

Under current law when 401(k) plans are controlled by workers, employers are not responsible for the results of workers' investment decisions. This safe harbor from liability would no longer apply during a black-out period.

Third, the President proposes to increase worker notification of black-out periods and provide workers with quarterly benefit statements about their individual pension accounts. The President's proposal requires that plan participants be given a 30-day notice before any black-out period begins.

To enable workers to make independent, informed decisions, employers will be required to give workers quarterly benefit statements that include information about their individual accounts, including the value of their assets, the rights to diversify, and the importance of maintaining a diversified portfolio. Under current law, employers are only required to make statements available to workers on an annual basis.

Finally, in order for employees to get the investment advice they need, the President advocates the enactment of the Retirement Security Advice Act, which passed the House with overwhelming bipartisan support.

This legislation encourages employers to make investment advice more widely available to workers and only allows qualified financial advisors to offer advice if they agree solely to act in the interests of employees.

The administration looks forward to working with members of this committee and all of Congress to ensure greater protections for the retirement benefits of all workers and their families, and I look forward to taking your questions.

The CHAIRMAN. Thank you very much, Mr. Sweetnam.

[The prepared statement of Sweetnam appears in the appendix.]

The CHAIRMAN. Mr. Kandarian?

STATEMENT OF STEVEN A. KANDARIAN, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. KANDARIAN. Chairman Baucus, Senator Grassley, members of the committee, thank you for inviting me to appear before the Senate Finance Committee. As the new executive director of the Pension Benefit Guaranty Corporation, I look forward to working with you.

Mr. Chairman, many Enron employees and retirees suffered a major financial loss as a result of the collapse of Enron. Certainly all of us feel great sympathy for their plight.

While the PBGC insures private-sector defined benefit plans, we have very little regulatory or enforcement authority over ongoing plans and no regulatory or enforcement authority over defined contribution plans such as 401(k)s.

When a plan that we insure terminates with insufficient assets, we pay participants and beneficiaries their pension benefits up to statutory limits.

The PBGC is still investigating the status of Enron's defined benefit plans, so the information I am providing today is preliminary.

The Enron corporate group has three major plans insured by the PBGC. The Enron Corporation cash balance plan is the largest, with 20,000 participants. It is the only one of the three that we think is under-funded.

The plan has approximately $220 million in assets, and although Enron has made all the contributions required by law, the plan appears to be under-funded by at least $125 million on a termination basis.

The PBGC takes over a plan when there is no likelihood that the employer will be able to maintain it, or when losses for the Federal insurance program would increase unreasonably if the plan continued. Neither is the case with Enron at this time.

The company is in the early stages of bankruptcy and its prospects are not yet clear. Workers are still earning benefits under the plan and we continue to monitor the situation closely.

The Enron plan started out as a traditional final average pay plan, switched to an arrangement known as a floor offset ESOP in 1987, and finally became a cash balance plan in 1996.

A person who worked for Enron under all three arrangements has a defined benefit pension consisting of three separate components. In 1985, the Internorth Corporation and the Houston Natural Gas Corporation, each of which sponsored a defined benefit plan, merged to form Enron. A year later, Enron merged the two plans.

Shortly before merging the plans, Enron split the Internorth plan into two separate plans and terminated one of them in order to receive a reversion of about $230 million. Enron used the reversion to help finance its ESOP.

In 1987, Enron changed the design of its defined benefit plan to a floor offset ESOP arrangement. Under this arrangement, the value of the Enron stock in the ESOP offsets the benefits accrued under the defined benefit formula for the period 1987 through 1994.

For example, if a participant had roughly $600 a month in a benefit under the defined benefit formula, and the ESOP is able to provide $400 per month at retirement, the defined benefit component would pay only $200 per month.

Enron's floor offset arrangement is not common. In general, the 1987 amendments to ERISA limited the amount of company stock in a floor offset arrangement to 10 percent. However, offset arrangements that existed prior to 1987 were grandfathered. Thus,

the 10 percent cap on company stock does not apply to a number of companies, including Enron.

In 1994, Enron froze benefits in the plan and set up a schedule to permanently fix the ESOP offset amount over a 5-year period. One-fifth of the value of Enron shares in the ESOP was fixed on January 15 of each year, from 1996 through 2000. Thus, by January 15 of the year 2000, it was known how much a participant would receive from the defined benefit portion of the arrangement.

At the same points in time as when the offset amounts were fixed, that is, each January 15 over this 5-year period, the plan released control of these ESOP shares to the participants. The participants were then free to sell their Enron stock and purchase other investments.

We do not yet have information on the impact of the offset on individual participants or on what the participants did with the released stock.

In 1996, the Enron plan adopted a cash balance formula for future years. It should be noted that the Enron conversion to a cash balance design did not result in so-called wear-away, in which workers earned no additional benefits.

The CHAIRMAN. Did not result in what?

Mr. KANDARIAN. A so-called wear-away.

The CHAIRMAN. Wear-away.

Mr. KANDARIAN. In which workers earned no additional benefits for a period of time. There have been some controversies over that.

The CHAIRMAN. Thank you.

Mr. KANDARIAN. Mr. Chairman, we will continue to monitor closely the Enron situation as it unfolds. Let me assure you that the PBGC stands ready to pay guaranteed benefits to participants and beneficiaries if it becomes necessary to terminate the plan.

Thank you. I would be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Kandarian appears in the appendix.]

The CHAIRMAN. Dr. VanDerhei?

STATEMENT OF JACK L. VANDERHEI, PH.D., TEMPLE UNIVERSITY, PHILADELPHIA, PA AND RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Dr. VANDERHEI. Chairman Baucus, Senator Grassley, members of the committee, I am Jack VanDerhei, a faculty member in the Fox School of Business and Management at Temple University. I am also the research director of the Employee Benefit Research Institute Fellows Program.

My testimony today will focus on retirement security and defined contribution plans, with emphasis on the role of company stock and 401(k) plans.

I wish to note that the views expressed in this statement are mine alone and should not be attributed to Temple University, the Employee Benefit Research Institute, or their officers, trustees, sponsors, or other staff.

I would like to highlight six points in my testimony today. First, most 401(k) plans do not include company stock as an investment option or a mandate. The EBRI ICI 401(k) database, a 5-year col-

lection of individual-specific data of more than 11 million participants from over 30,000 plans shows that only 2.9 percent of the plans included company stock.

However, the plans that do have company stock are generally quite large and represented 42 percent of the participants. In terms of account balances, plans with company stock account for 59 percent of the universe.

The fact that plans with company stock had higher than average account balances was no doubt partially due to the bull market preceding this time period, but may also be a function of the plan's generosity parameters and average tenure of the employees.

Second, the overall percentage of 401(k) account balances in company stock has remained consistently in the 18 to 19 percent range from 1996 to 2000. However, when the analysis is limited only to those plans that include company stock, the average allocation increases to approximately 30 percent.

Third, several proposals have called for an absolute upper limit on the percentage of company stock that an employee will be allowed to hold in his or her 401(k) account.

Analysis of the EBRI ICI data shows that a total of 48 percent of the 401(k) participants under age 40 in those plans that offer company stock have more than 20 percent of their account balances invested in company stock. That percentage decreases slightly to 41 percent for participants in their 60's.

Fourth, some employers require that the employer contribution be invested in company stock rather than as directed by the participant. Participants in these plans tend to invest a higher percentage of their self-directed balances in company stock than participants in plans without an employer-directed contribution.

Company stock represents 33 percent of the participant-directed account balances in plans with employer-directed contributions, compared with 22 percent of account balances in plans offering company stock as an investment option, but not requiring that employer contributions be invested in company stock.

Fifth, what would happen if a minimum rate of return were guaranteed for 401(k) participants? Proposals have been suggested recently that would attempt to transfer part or all of the investment risk inherent in defined contribution plans from the employee to another entity. Although the party initially exposed to said risk varies among the proposals, the likely targets could be the employer, the government agency, perhaps the PBGC, and/or a private insurance company.

While the cost of the guarantees and/or financial uncertainty inherent in such an arrangement may be borne by the employer, at least initially, it is unlikely in the long term such a shift in risk-bearing would not somehow alter the provisions of existing defined contribution plans.

It is obviously impossible to model the financial consequences of such a proposal until additional detail is provided. However, a highly stylized example of one method of achieving this objective can be readily simulated.

Assume, for example, a proposal that required the employer to ensure that participants receive an account balance no less than what would have been obtained under a minimum rate of return.

While some employers may choose to voluntary assume the additional cost of this arrangement, others may wish to rethink the investment options provided to the employees and provide little or no participant direction.

In fact, an easy way of mitigating the new risk imposed by the minimum guarantee would be to force all contributions, whether contributed by the employee or the employer, into a relatively risk-free investment.

While this is unlikely to be popular with young employees and other participants desiring high, long-term expected returns, it would minimize the new risk shifted to the employer.

Figure 2 in my written testimony shows the expected results of running one such proposal through a simulation model I created for this testimony. Instead of allowing employees to direct their own contributions and perhaps those of the employer, assume employers are forced to guarantee a minimum rate of return of 5 percent nominal, and they are able to find a GIC or a synthetic equivalent that will provide that return in perpetuity.

If all existing balances and future 401(k) contributions were required to be invested in this single investment option, the average expected reduction of 401(k) account balanced at retirement would decrease between 25 and 35 percent for participants born after 1956.

While the results in Figure 2 are specific to the assumptions mentioned above, similar results are obtained, albeit with different percentage losses, under various combinations, minimum guarantees, and assumed asset allocations and rates of return.

Finally, very quickly, what happens if company stock were removed from 401(k) plans? I simulated the overall gain or loss from prospective retention of company stock and 401(k) plans as opposed to company stock being eliminated entirely for birth cohorts between 1936 and 1970.

The results indicate the estimated gain of retaining company stock is either 4.0 percent or 7.8 percent of 401(k) balances, depending on the assumptions used. There would, as you know, however, be a wide distribution of winners and losers from retaining company stock.

That concludes my oral testimony. I would like to thank the committee for the opportunity to appear today, and I would be happy to respond to any questions you may have.

The CHAIRMAN. Thank you, Dr. VanDerhei, very much.

[The prepared statement of Dr. VanDerhei appears in the appendix.]

The CHAIRMAN. Mr. Huss?

STATEMENT OF R. BRADFORD HUSS, ESQ., TRUCKER HUSS, SAN FRANCISCO, CA

Mr. HUSS. Mr. Chairman, Senator Grassley, members of the committee, thank you for inviting me to testify today. My name is Brad Huss, and I am a partner in the San Francisco law firm of Trucker Huss, which is one of the largest employee benefit law firms in the country.

I have been actively litigating ERISA cases for over 20 years and I have represented both plan participants, as well as employers.

I am also a member of the board of directors of ASPA, on whose behalf I am testifying today. ASPA is a national organization of over 5,000 retirement plan professionals who provide services for qualified retirement plans covering millions of American workers.

ASPA applauds this committee's leadership in exploring how our Nation's pension laws may need to be strengthened. However, it is critically important that any legislative response to the Enron tragedy be carefully measured.

I would like to summarize ASPA's views on several issues. One, insuring access under ERISA to remedies for individual plan participants who have suffered a monetary loss from a breach of the fiduciary rules under ERISA; two, making sure that plan sponsors can change service providers to improve plan administration without being subject to undue restrictions or liability; three, improving the diversification of participant-directed plan investments; four, encouraging employers to provide investment advice; and five, strengthening the retirement security of American workers.

With respect to participant remedies, ERISA does impose strict fiduciary duties concerning the management of pension plans and provides for liability for breaches of those duties.

One problem that does exist under ERISA, is that plan participants have been restricted in their ability to obtain individual relief from monetary losses to their plan accounts caused by a fiduciary breach.

A recent case demonstrates this situation. In *Helfrich* v. *PNC Bank*, decided this past October, a participant in a 401(k) plan brought an action under ERISA against a plan trustee for breach of fiduciary duty.

Mr. Helfrich was preparing for retirement and directed the plan trustee to transfer his account balance into certain mutual funds, but the trustee failed to do so.

Mr. Helfrich brought a claim, asking that he be compensated for his losses due to the plan trustee's failure to follow his directions. The court, however, found that his requested remedy constituted money damages, not restitution, and it was therefore unavailable to him under ERISA.

We believe that ERISA, Section 409(a) should be amended to provide that individual plan participants can bring actions against plan fiduciaries to obtain the remedies provided by that section on their own individual behalf.

As we have been discussing today in the aftermath of the Enron situation, proposals have been made to place time limits on so-called lock-downs or black-outs. In the experience of ASPA members, lock-down periods are necessary in order to permit the orderly change of plan service providers. This is done many times for the purpose of improving the investment alternatives or other plan features offered to plan participants.

ASPA believes that advanced notice of lock-downs should be required, but opposes any predetermined restrictions on the length of lock-downs.

ASPA does agree, as suggested by the administration, that employers should bear the fiduciary responsibility of monitoring plan investments during a lock-down. However, while it is appropriate to impose that responsibility on employers, those employers, par-

ticularly small businesses, need regulatory guidance on how to comply with that responsibility.

Another issue raised by the Enron situation is the investment of plan assets in employer stock. ASPA believes that employees should generally be provided with choice as to investing in employer stock.

However, in enacting any changes to increase employee choice, care must be taken to address the special concerns and situations of small businesses whose stock is not publicly traded.

Diversification of investments is clearly the best protection against significant losses in retirement savings. ASPA believes that the best way to promote diversification is to make it easier for employers to provide investment advice to plan participants.

ASPA supports the proposed Independent Investment Advice Act introduced by Senator Bingaman of this committee, and Senator Collins. This bill would provide employers with a safe harbor, allowing them to satisfy their fiduciary obligations, thus facilitating the provisional investment advice to participants.

Finally, we believe the most effective way to strengthen the overall retirement security of American workers would be to revitalize the use of defined benefit plans.

Unlike 401(k) and other defined contribution plans, defined benefit plans provide a guaranteed retirement benefit for employees and, very importantly in a defined benefit plan, the risk of investments is borne by the employer and not by the employees.

On behalf of ASPA, I thank the committee for the opportunity to present our views today. I would be glad to answer any questions.

The CHAIRMAN. Thank you, Mr. Huss. I am sorry, I missed your last point about defined benefit. What is your recommendation?

Mr. HUSS. We need to find ways to revitalize the use of those plans.

The CHAIRMAN. Revitalize. Revitalize. Thank you.

[The prepared statement of Mr. Huss appears in the appendix.]

The CHAIRMAN. I have a question for you, Mr. Huss. What causes of action like today under current law, on behalf of the participants, against whomever to try to recover their losses?

Mr. HUSS. Well, there are two main causes of action under ERISA. This is Section 502. One, is to bring a suit under Section 409 of ERISA on behalf of the entire plan. The other, is to bring a suit under Section 502(a)(3) of ERISA for violation of the Act. That can be brought by individual participants for their own behalf, but it only provides for equitable relief. It does not provide for monetary damages. That goes to the issue I was addressing on remedies.

If an individual sues on his own behalf, an individual participant, not on behalf of the whole plan but on his own behalf, under the current state of the law, monetary damages are not available to that participant and we think that should be corrected.

The CHAIRMAN. All right. So what are the chances, under current law, of success on either someone who sues on behalf of a plan or in his own right?

Mr. HUSS. Well, if you sue on behalf of the plan—take the Enron situation. A number of class action complaints have been filed.

The CHAIRMAN. Right.

Mr. HUSS. I have read them. If the allegations made in those complaints can be proven to be true, I think liability will be established. Of course, there is obviously an issue of whether assets will be available to satisfy any judgments.

One thought would be to give participants standing or priority in bankruptcy matters so that if the company goes under, the plan participants who prove liability will still be able to collect.

The CHAIRMAN. So in addition to winding up in bankruptcy, the other recommendation you have is the remedy.

Mr. HUSS. Yes.

The CHAIRMAN. Again, you think the remedy should be monetary damages?

Mr. HUSS. It would be a very simple change to Section 409 of ERISA. The Supreme Court, in the case of Massachusetts Mutual v. Russell, interpreted that section, saying that a participant can only sue on behalf of damage to the whole plan.

It needs to be changed so that a participant can sue under that section, which does provide broad remedies, but it needs to be changed so that a participant can sue on their own behalf.

Suppose only one person's account is damaged in the plan, unlike Enron where a vast portion of the plan was damaged. In the Helfrich case I mentioned, it was only one person's account that was damaged and the court found he had no viable remedy for monetary damages.

The CHAIRMAN. I would like to ask any of the three of you at the left of the table the degree to which the administration's proposals here would have protected or prevented the loss of Enron participants. You all can answer that question.

I ask it, because it is my understanding—please correct me if I am wrong—that generally the Enron employees voluntarily purchased company stock and they also did so knowingly.

They had an opportunity—that is, not totally knowingly—to leave, to divest. I am wondering the degree to which the proposals themselves would actually prevent losses in this case, or whether there is more to it.

Mr. SWEETNAM. Well, Mr. Chairman, I believe that they would——

The CHAIRMAN. Mr. Sweetnam, I think I will have your answer later on. I am going to ask somebody else who is a little more independent of the proposal to give their views, and you can defend.

Mr. SWEETNAM. Oh. Thank you.

The CHAIRMAN. Any of you three want to take a crack at it?

Mr. SWEETNAM. Well, he is with me, too.

The CHAIRMAN. I know. So the two on the left. [Laughter.]

Dr. VANDERHEI. It is highly speculative, but I think it very much depends on what type of disclosure notification is given in the quarterly statements. There is an extreme amount of variation from one plan to the next when company stock is offered.

I am obviously not referring to the match now, but as far as whether the employees tend to follow the employer with their investments into company stock depends a lot on which plan you are looking at. To a large extent, that is going to be based on how well the company stock has been doing in the past.

I fear it may be difficult to take a situation in which the employees are looking at a company stock that has outperformed the market quite well in the last few years, and regardless of what you tell them about diversification, they think they are going to be following a winner.

It remains to be seen how effective that type of education, or communication, or disclosure can be as far as convincing employees to voluntarily diversify their own contributions.

The CHAIRMAN. Just to try to sharpen up this question a little more, in the interest of trying to find the right legal, Congressional solution here, it is my understanding that most of Enron's employees voluntarily were concentrated heavily in their company stock.

It is true that some were restricted, but the information I have is that the company estimates that the restrictions accounted for less than 10 percent of the company's shares in the plan, and many workers knew they were engaged in risky investment behavior but bought Enron shares anyway because they believed in their company. While there was a significant drop in stock during the black-out period, stock had already lost two-thirds of its value before the black-out period.

In the interest of making sure we do not try to pass something here that people say is going to work but really will not, with all best intentions, I would just ask again the question, the degree to which these proposals suggested—and I think they are good proposals, by the way. I am not being critical of the proposals—they nevertheless would have prevented, if enacted and current today, the loss.

Dr. VANDERHEI. Well, I think the frequency of disclosures would help a great deal. If every three months you are being given some type of statement that shows your degree of concentration, and presumably what the rate of return has been on the stock, that may open the employees' eyes to the volatility that is inherent in, let us say, company stock vis-a-vis a diversified equity fund.

The CHAIRMAN. Mr. Huss, any thoughts?

Mr. HUSS. Yes. I think the best way to encourage participants to diversify to avoid that over-concentration in employer stock is to provide them with investment advice.

Right now, of course, employers can, if they choose, provide investment advice to their participants, but many employers do not. In fact, surveys have shown the main reason employers do not provide investment advice is fear of incurring liability.

Senator Bingaman's bill addresses this point head on and provides a safe harbor for employers who choose to provide investment advice. You can lead a horse to water, but you cannot make them drink.

But if you provide them with specific advice as to investments in their plan, not just education but advice, hopefully they will take it. Of course, a keystone of that advice will be diversification.

The CHAIRMAN. Mr. Sweetnam? My time has expired, so I will give you time to respond.

Mr. SWEETNAM. I also agree that probably the keynote of our proposal with regard to the Enron employees would have been getting them investment advice, because if they were told by someone from the outside that it was a risky proposition to have all of their

money, or a sizeable portion of their money, invested in employer stock they would have done something.

I believe that there was testimony in one of the earlier hearings here on the Senate, where one of the plan participants said they got outside advice and, as a result of the outside advice, they decided to diversify in their investments.

The CHAIRMAN. Thank you. My time has expired.

Senator Grassley?

Senator GRASSLEY. Yes. Thank you, Mr. Chairman.

Thank all of you for your participation. I do not have questions for all of you, but I am going to concentrate on Mr. Sweetnam. That is not just because the Chairman concentrated on the rest, but I do want to get some facts out because there are differences in my bill from what the administration has recommended.

Given the abuses of company stock at Enron and Global Crossing, can you provide the committee with some insight as to why the administration rejected caps on stock in accounts?

If a rule were adopted to mandate such caps, what mechanisms would need to be used to eliminate the excess amount of stocks that might accrue in such an account? Also, would so-called benefit wear-aways be required?

Mr. SWEETNAM. The administration, in their proposal, really looked at caps and decided against them because we did not think that an overriding government cap would really do the right thing.

I think one of the things you have to look at, is you have to look at people's overall financial situation to determine whether 20, 15, or 10 percent within one plan is an appropriate level.

So what we suggest, is that employees get more information, advice to make them be able to utilize their plan to more effectively diversify. Really, a one-size-fits-all solution, we did not think, was the right solution there.

I think the other thing is, you have to look at some of the administrative complexities of doing caps. We do have a cap in ERISA for defined benefit plans, but that is when you were looking at one plan. It is very easy. At the end of the year, you can look at the plan and you know whether you have exceeded those caps.

Here, you are going to have to look at it participant by participant to determine whether the caps have been met or they have not been met.

The other thing is, it does have really perverse investment incentives. At times when the stock is rising, it may be the time that you want to stay a little bit longer in that stock. However, the government is telling you, no, you must diversify out against it.

Let us say that another time your other investments are going down. Well, at that time then the government is telling you that really you have to diversify out of your company's stock and go into the other funds that are going down. So, we were really concerned about that.

Senator GRASSLEY. The idea of having the government set up some type of insurance program for 401(k)s and other defined contribution plans has been raised. How appropriate is it for the Federal Government to insure defined contribution plans, and would all workers have to purchase, for instance, U.S. savings bonds as their sole investment option?

Mr. SWEETNAM. Well, as you know, there has not yet been any legislation introduced on this, so we do not have any particular comments on particular legislation.

However, we have been looking at this. I think that I would like to just raise some of the issues that we think of when we are looking at some sort of insurance with regard to defined contribution plans.

The first thing we look at is moral hazard. What I mean by moral hazard, is if you were going to be insuring against something, then what you want to make sure of is that the employee does not engage in behavior that sort of forces you to use the insurance. So, for example, I could make sure that I have insurance, but then I could invest in the most risky funds. That is sort of the moral hazard problem.

If you address the moral hazard problem, which one commentator has addressed, what she said was, what you would do is you would provide insurance if you have just a limited number of investment options, and you sort of lock into those investment options over a long period of time. If you do that, of course, what you are doing is you are eliminating the choice of the employee to make the appropriate investment changes that they want to.

Another thing that we look at, is that there are current investment vehicles that can get you to the place where insurance gets you. For example, a plan could offer an annuity which would have a guaranteed floor benefit, so that that would do the exact same thing as some sort of an insurance guarantee. You would invest in the annuity. The annuity would give you a rate of return, but it would guarantee that your investment does not go below a certain level.

Finally, I think one of the issues that you really have to worry about is, where would that insurance be situated? Would you be situating an insurance like that by a new government agency, or maybe expand Mr. Kandarian's agency to provide that, or would you be doing this on a voluntary basis with some sort of private insurer?

Senator GRASSLEY. Mr. Chairman, could I have one more question?

The CHAIRMAN. Go ahead. Yes. Sure. Absolutely.

Senator GRASSLEY. Then I will not have to use the second round. Pardon me, Senator Lincoln.

I spoke about my bill, trying to make it as consensus as I could. One of the controversial bills that is on the hill now in this committee is Congressman Binger's bill.

The issue of guidance from an investment advisor comes up to whether or not there are any sort of problems that exist because they could use their own products as investment options.

Why do you think, because I know the administration is backing this approach, that investment advice would change participant behavior? I think maybe you have addressed that in response to Senator Baucus.

But why would the advisors not maybe cherry pick the rich accounts and neglect the rank and file, or worse, make these rank and file go through kind of a cookie-cutter type, impersonal computer program that workers probably would not use? Then what

would be the enforcement mechanism when an advisor manipulates investors?

Mr. SWEETNAM. Well, with regard to your first question, if the plan paid for the investment advice itself, or the individual paid for the investment advice through the plan, we would consider that to be a plan provision. Plan provisions really must provide the same availability, the same effective availability, to all the people within the plan.

So you could not give, as a plan benefit, this investment advice being part of the plan benefit, greater investment advice to the executive and have lesser investment advice for the individual.

Let us say now that we do not make this available through the plan, but we make it available on a pre-tax basis, or as an employer-subsidized basis outside of the plan.

Well, last year in EGTRRA, your bill made it very clear that an employer offering that sort of investment advice outside the plan would be tax-free. But the most important thing that you said, is it had to be effectively available to everyone.

So, again, you would not be in a situation where the executive would get more investment advice or a different type of investment advice than the lower-paid person.

Now, of course, you could do changes based on something like age or status close to retirement. You could make those sorts of changes. So, I think that was one of the things that we had talked about.

Senator GRASSLEY. All right. Then the point about enforcement mechanism if an advisor would manipulate investors.

Mr. SWEETNAM. Well, I think we are really looking towards the current fiduciary rules and the disclosure to really be the enforcement mechanism under our investment advice bill. Again, an investment advisor would be a fiduciary with regard to the advice that he or she gave to the participant. He would have to act towards the interests of the participant.

So what we would say, is an investment advisor that is deciding he will use Mutual Fund X—I believe Mr. Walker used Mutual Fund X as the example—and Mutual Fund X was providing the investment advice.

If Mutual Fund X was advising people to go into the X mutual fund, which was a fiduciary breach, it was not for the best interests of the participants, the participant could sue Mutual Fund X, also the Department of Labor could sue Mutual Fund X. So, we believe that that gives us comfort about this.

Senator GRASSLEY. All right. I thank you, Mr. Chairman, for permitting me to go beyond my time.

The CHAIRMAN. Thank you very much.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

Thank you to the panel. I apologize that I had to excuse myself for a few moments and may have missed some of your testimony.

But the story of the Enron crash really continues to provide example after example of how top Enron officials made themselves multi-millionaires while Enron employees, Enron creditors, and Enron investors lost millions. I use one example specifically in my

State of Arkansas. The Arkansas Teacher's Retirement Plan lost $47.5 million in an investment in Enron.

Mr. Chairman, the hardworking teachers of my State and all of those who have lost money really deserve answers, and that is why we are here today and we will continue to follow this issue.

So I commend the Chairman for holding this hearing in order to get some answers and for us to hopefully formulate some ideas on ways to avoid any future crises or inequities. We appreciate the input that you gentlemen can bring to that.

Along these lines, there are many questions about how the top Enron officials have been able to protect their special executive pension plans, while the rank-and-file employees saw their regular 401(k) retirement savings devastated.

Enron did this through various mechanisms, including an executive savings plan that guaranteed, I believe, a 9 percent return, and then an executive 401(k) that guaranteed a minimum 12 percent return, among some others.

Mr. Sweetnam, due to my time limitations, I want to focus on just one of these special plans for the top executives that are not available to regular workers, and that is the split-dollar plan.

In the Enron case, Enron agreed to pay a total of $1.25 million in insurance premiums on a $12 million life insurance policy for Mr. Lay in order to fund a split-dollar plan.

Ultimately, Enron would be able to recoup this premium, and at the same time Mr. Lay could borrow against the policy tax-free or leave the funds to his family tax-free. This was a typical arrangement, I believe, for the top Enron officials.

So, basically, a split-dollar plan—and I am a layman here. I do not have the background you do—is really a tax-deferred investment wrapped into a life insurance policy, which the Tax Code allows and the American taxpayer pays for.

But on top of this, I understand that six States, including Texas, have laws to protect these investments from the attack of creditors. Further, I also understand that the benefits of these executive savings plans are not required to be disclosed in SEC filings. I believe that is correct.

But I also have become aware and understand that the Treasury Department has provided new rules to grandfather billions of dollars in existing policies under split-dollar plans and it allows for new rules, actually, to craft new split-dollar plans.

My question to you, Mr. Sweetnam, in light of the Enron crash, how does the American investor and the American taxpayer, the American business who provides credit, and American workers benefit from these split-dollar plans, and why is the Treasury Department encouraging their use, particularly at this time?

Mr. SWEETNAM. Thank you, Senator. That's a very good question. Last year, in 2001, the Treasury Department and the IRS imposed some new tax rules on split-dollar arrangements that had immediate and retroactive effect, with no transition relief on preexisting arrangements.

Split-dollar life insurance plans have been around for a long time, and really there has been very little guidance given on them up until last year.

When we came in, we looked at this and we did a new notice last month.

Senator LINCOLN. Right.

Mr. SWEETNAM. And our new notice confirmed that we would be taxing split-dollar life insurance, and we provided an overview of the rules that are going to be proposed. We are working to get out proposed regulatory guidance, something that has been long overdue, in the next few months.

But what we also did, is we provided transition relief because people had taken advantage of our no-ruling position for so many years, that it would be unfair for us to come in and sort of completely overturn what we never enforced in the first place.

So what we did, is we allowed current split-dollar arrangements to elect into the new rules. We also said that for the time period between our notice coming out and the final regulations being finalized, we gave very strict rules.

We made it very clear what the rules were for these new plans, and then once the final regulations come out, people will be able to follow with new arrangements with the new regime.

But I think what we were really trying to do, was not to come in and completely overturn some rules that we never, for over 30 years, made any real attempt to provide really good guidance on.

Senator LINCOLN. Just to make sure that I am clear, you are speaking of what happened in the regulations that were put out under the Clinton administration.

Mr. SWEETNAM. The Clinton administration put out a notice for that.

Senator LINCOLN. Well, you had said "us," so I just wanted to make sure I was clear on that.

Mr. SWEETNAM. Oh, I am sorry. "Us," Treasury.

Senator LINCOLN. All right.

So I am clear on this, then what you are telling me is it is not the intention to grandfather indefinitely, but you are saying that there is going to be a limited time on what you are doing here?

Mr. SWEETNAM. What I am saying is, is the arrangements that were in place at the time we issued the notice would be grandfathered under whatever the old rules were. We give those contracts the ability to switch into the new rules if they would like to.

With regard to arrangements that are entered into after the January, 2002 notice and before the finalized regulations, we have made it very clear in the notice what the rules were. They are stricter than what the old rules were.

Senator LINCOLN. Well, I think I understand what you did, which is what you have just described, which is what the reversal of the regulation was. I guess I still go back to my final question. That is, why is the Treasury encouraging this?

I mean, it may be something that was allowed to happen for 30 years without the appropriate oversight or the appropriate regulation. Particularly at this time under these circumstances, I guess, would it be something we want to encourage?

Mr. SWEETNAM. Well, the guidance that we have given for plans for split-dollar arrangements that are entered into after the effective date of our notice, which was last month, they would be under the similar rules to the rules that the Treasury, under the Clinton

administration, proposed last year. It is just a lot clearer what those rules were.

Senator LINCOLN. Well, then I am just assuming from your response that you think that this is good policy, that the taxpayer should be subsidizing this.

Mr. SWEETNAM. Well, I think what we are worried about is that, number one, we do not like to overturn products and arrangements that we have given no guidance on over the years. That is why we put in the grandfather for old arrangements.

Under these new arrangements, we have made it very clear that there are two different ways in which you can provide split-dollar life insurance. One way that you can provide split-dollar life insurance is with the corporation owning the policy, and then you, the employee, getting taxed on the benefit of the life insurance protection that you get.

Senator LINCOLN. But this is something only available, truly, to the executives.

Mr. SWEETNAM. It can be available to whomever, but it is not like a qualified plan where we require everyone to get it. A lot of times these are used to secure deferred compensation arrangements, and deferred compensation arrangements do not go to the rank and file, normally.

Senator LINCOLN. Right. Well, just in light of what we are discussing, the inequities and what we want to present as being more equitable, I am just curious to know if it is the Treasury's position that this is something we want to encourage, and is it something that really is going to benefit the workers, the taxpayers that provide the credit, and everybody else.

Mr. SWEETNAM. Well, I think that what we are trying to do, is if under these new rules, if companies decide that this is a way to compensate executives, we are making it very clear what the tax ramifications of those compensation arrangements are.

I guess, to talk about the way that we tax executive compensation arrangements, somehow reflects upon the fact that there are executive compensation arrangements that are not available to rank and file, and that we should not address the taxation of that, or we should make sure that we give unfavorable tax treatment to executive compensation arrangements. I am not sure whether that is the way the Treasury would be looking at this.

Senator LINCOLN. I will be interested to see where you go further with that, just in terms of, as I said, in light of what we are looking to do in providing equity for shareholders and everybody concerned in the investment community. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

I would like to know whether, Mr. Huss, and there has been earlier discussion on this point, and that is the floor offsets. Prior to 1987, there were, I guess, a significant number and some were grandfathered. I guess all of those prior to 1987 were grandfathered.

There is sort of a tone here that those floor offsets perhaps are not the best idea. I am wondering whether we should eliminate the grandfather somehow, or address the grandfather. Mr. Huss?

Mr. HUSS. I think we would agree with the views expressed on that by Mr. Walker, that they should be examined. Are they an indirect way to get around the limit on employer stock and defined benefit plans?

The CHAIRMAN. All right.

What do you think about that, Mr. Kandarian?

Mr. KANDARIAN. Senator, I think there were something like 150 companies back in 1987 that had these floor offset ESOP arrangements. We are undertaking an effort at the PBGC to try to find out how many of those companies still are in existence and have these arrangements. So the scope of the issue, and the problem, I think, is still to be determined.

The CHAIRMAN. But you are looking into it?

Mr. KANDARIAN. We are looking into it.

The CHAIRMAN. You said something that kind of caught my ear a bit in your testimony. It is on page 3. You said that "PBGC estimates that the Enron plan, with about 20,000 participants, had approximately $220 million in assets." I guess this is the cash balance plan. "And is under funded by at least $125 million on a PBGC termination basis."

I wonder, was Enron in compliance with funding requirements?

Mr. KANDARIAN. They were, Mr. Chairman. The funding rules differ from plan termination assumptions, so there can be some fairly large divergences in terms of the numbers. Enron had made all the required payments under the regulations. However, when a termination occurs, different assumptions spring forth.

For example, people are likely to retire earlier if a company has gone out of business. There are also a number of other kinds of actuarial assumptions such as those related to interest rates. An ongoing plan might have one interest rate, a higher interest rate, but for a plan termination a much lower interest rate is used by the PBGC. The PBGC rate is basically a private market rate for getting an annuity in the private markets. That is a more conservative number.

The CHAIRMAN. Should we address the requirements? Are they a bit loose?

Mr. KANDARIAN. Well, I think it is really apples and oranges. One is for ongoing plans, the vast majority of which are ongoing and continue for years and years.

The other is typically for a small percentage of companies that not only go bankrupt, but actually do not come out of bankruptcy with their plans continuing PBGC is put in a position of taking over those plans. Let us say, about half of the bankrupt companies since 1974 had their plans continue. They were not terminated. They did not come to us. So, there are really different measures here.

The CHAIRMAN. Senator Lincoln raised, I think, a lot of very good questions which this committee is now looking into and will be addressing later at a subsequent hearing.

But in conjunction with that, I am just wondering, again, about the advice in giving participants better advice. I think it is true. I think a lot of participants just need a lot more advice as to what to do, what not to do.

My personal view is, every high school should have a required course on personal finance, balancing a checkbook, and what are stocks, what are bonds, and what is the difference between debt and equity, and so forth.

I mean, if people have a little better sophistication at an earlier age, I think it would go a long way. I think in many ways it would improve the productivity of this country, and the economy in this country. Having said that, we are not there yet.

In the case of Enron, let us say, it appears that at least some executives knew the company was facing significant financial troubles. I am just wondering whether there should be some requirement that prevents those executives from telling participants, gee, we have got a great company.

Or stating it differently, should those executives not have some obligation to inform employees or plan administrators that, hey, something is not right. Participants, you had better do something about this or you are going to be taking a bath.

Mr. SWEETNAM. I think, Mr. Chairman, one of the things is that, under the current fiduciary rules, if the person is a fiduciary depending on what they do, and if an executive is telling employees to invest in the 401(k), it could be seen that he is acting in a fiduciary capacity, giving investment advice. So under the current law, that executive would be under some——

The CHAIRMAN. Would that apply to Mr. Lay or Mr. Skilling, who would generally say, boy, our company is really going. I even have some quotes here. This is August 27 of last year. Kenneth Lay said, "As I mentioned at the employee meeting, one of my highest priorities is to restore investor confidence. This resulted in a significantly higher stock price. I hope this grant lets you know how valued you are to Enron."

Then on September 26, he said he anticipated that stock, which had dropped to just $25, would rebound. He touted the company's overall financial picture: "our third quarter is looking great. We will hit our numbers. We continue to have strong growth in our business. I think we are very well-positioned for a very strong fourth quarter."

He said, "Urge employees to talk up the company stock to friends and family," when he knew, certainly, because he was selling stock, Skilling was selling stock, that what he was saying was just totally false.

Mr. SWEETNAM. I think that you raise a very good point, Mr. Chairman. I think one of the things that the administration is doing, is we also, in addition to having the Pension Task Force, we also have a Corporate Governance Task Force. A lot of these things where they were making these claims, they are making these claims wearing, really, two hats.

One may be as a plan fiduciary, advising employees to invest their 401(k) assets, but also in their fiduciary hat as a corporate officer. I think one of the things that we are looking at, is various corporate governance things. We know that Secretary O'Neill is very, very interested in looking at that.

The CHAIRMAN. I just saw the Secretary, so I note those statements. It gets to the point, and you are touching on it, that Senator Breaux made. It is one thing for a plan fiduciary to make state-

ments like that, but it is also in some cases even worse for the CEO who may not be a fiduciary to make those statements.

Mr. SWEETNAM. Exactly. Exactly. We have a Corporate Governance Task Force which Secretary O'Neill is on, and I believe the head of the SEC, the Federal Reserve, and the head of the Commodity Futures Trading.

The CHAIRMAN. That is correct.

Now, this gets a little bit into conflict of interest that, let us say, a financial services company, Mutual Fund X, they have been giving investment advice to a participant.

If I understood you correctly—I am sorry I stepped out for just a minute during your conversation with Senator Grassley—your point is that the participant is protected because he or should would have a fiduciary action with respect to the person who may have violated fiduciary responsibility by giving advice that is not in the best interests of the participant. Is that sufficient?

Mr. SWEETNAM. I think you have to look at it in concert with all of the other requirements that we have for these individuals. We do have extensive disclosure requirements, that these people that are giving the advice have to be from qualified financial institutions such as banks, mutual funds, life insurance companies, and the ultimate fiduciary rules will help in stopping people from giving advice that——

The CHAIRMAN. I guess I am just raising the question, and I was struck with Mr. Walker's statement that you cannot solve a conflict with disclosure. There is a lot of truth in that.

The disclosure is not sufficient. If, say, an advisor who has a conflict is giving pretty sophisticated advice, it is pretty hard for an unsophisticated participant to know what is up, even when there is disclosure.

Second, I am just concerned, and want to explore with you a bit, that puts a big burden on the participant to have to bring an action against somebody who the participant thinks has violated some conflict of interest and have violated fiduciary obligation, do you not think?

Mr. SWEETNAM. Well, it is. They can also turn to the Department of Labor, but you are correct.

The CHAIRMAN. Does that not mean we really should have independent advisors?

Mr. SWEETNAM. Well, one of the things right now, Mr. Chairman, is the fact that you could provide independent investment advice. Unfortunately, that is not happening. I think one of the things that we are trying to do——

The CHAIRMAN. Why is it not happening?

Mr. SWEETNAM. Well, I believe that plan sponsors are not going out looking for that sort of advice. However, if it is your plan administrator or the person that is helping you administer the plan, they are in a very good position to come in and say, we can offer this additional service. We can do it. It makes it very helpful for them to do this.

The CHAIRMAN. Well, I appreciate that. The goal here is to get more confidence, the public's confidence, investors' confidence, participants' confidence in plans. I know that is your goal, too, Mr. Secretary.

But I would just urge all of us to maybe go the extra mile and remember to keep our eye on the ball. That is, confidence in the system, and so forth. It is trying to find that line between too much freedom and flexibility on the one hand, and too much control and regulation on the other.

But I do think, in just my gut, that there is going to be more confidence if a participant, in seeking advice, knows that this person really is independent. That is going to go a long way.

Mr. SWEETNAM. Well, I think we agree, sort of across the board, that people should be getting investment advice. I think we can all work to try to get there.

The CHAIRMAN. Well, I thank you all. This has all been very helpful. Of course, this is just one step down a very long road. There will be lots of twists and turns.

But thank you very, very much for your help. You have been very helpful, and we deeply appreciate it. Thank you.

The hearing is adjourned.

[Whereupon, at 4:18 p.m. the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Charles E. Grassley

Since the Enron and Global Crossing controversies erupted, I've been concerned about the larger consequences these bankruptcies have for retirement plans across the country. What we've learned about so far and will continue to explore are problems with manipulation of employer stock in retirement plans. Based on what we know, today I'm introducing legislation which I hope will enjoy wide support from members of both parties. Consequently I've looked at the issues of consensus and included them in my bill. They are:

- New diversification rules for company stock in plans.
- Improved disclosure prior to black-outs and clarification of fiduciary requirements.
- Parity between treatment of rank-and-file workers during a blackout and executive stock trading rights.
- Better information for participants through periodic benefit statements and retirement education and information.

I've spent a lot of years trying to help Americans save more money for retirement. In fact, Mr. Chairman, you and I introduced legislation only last year that made dramatic differences in people's ability to save for their retirement. That bill was enacted as a part of the tax relief bill that the President signed into law last June. So it's especially tragic that at both Enron and Global Crossing, workers lost so much retirement money, while top executives were lining their pockets with gold. I have Enron subsidiary employees in my state, so my interest is not just abstract.

The Internal Revenue Code gives substantial tax preferences to companies that sponsor retirement plans. In exchange, the plans have to be operated in compliance with the Code and the *Employee Retirement Income Security Act* (ERISA). This Committee has exclusive jurisdiction over the Code and over significant parts of ERISA. As a result, the Senate Finance Committee ought to take action and exercise its jurisdiction to guard against abuse.

One of our jobs is to exercise our oversight responsibility to see that strong enforcement programs are in place in the Treasury, the IRS and at the Labor Department. We have to make sure certain programs protect workers, the government and financial markets against manipulation and abuse.

(By the way, and speaking of the enforcement program at the Labor Department, I'm sorry that the Assistant Secretary for Pensions could not fit it into her schedule to appear before the Finance Committee. I think it would have added a lot to the hearing to have a representative of DOL here.)

In addition to oversight, our other job is to legislate. We have to make sure the laws do what we say they're supposed to do. These jobs of oversight and legislation must be carried out in the context of the voluntary retirement system.

Our responsibility to legislate is why I'm introducing the *National Employee Savings and Trust Equity Act*, NESTEG(G) for short. I think current law can be improved and so I took action. I did this because of what I believe may have been unfair restrictions on stock in retirement plans that ultimately cost some unsuspecting workers their retirement money—money for which tax benefits were given.

But I've been criticized because of my efforts to be non-partisan. There are those who want to interject contentious issues in retirement legislation. I don't think that's the way we ought to go. I've included the items where I think there is general agreement, but where there isn't, I let that field lie fallow, so to speak.

I realize there have been discussions about preventing the Finance Committee from exercising its jurisdiction over retirement plans and handing the issue over to

the Labor Committee. I know of no reason why we should cede our jurisdiction over retirement plans. I hope the Committee will move quickly to report legislation that will extend protections and tax penalties where they're needed, before there are more Enrons and Global Crossings and more dashed hopes for a secure retirement.

Prepared Statement of R. Bradford Huss, Esq.

INTRODUCTION

Mr. Chairman, members of the Committee, thank you for inviting me to testify today on retirement security and possible proposals to reform our nation's pension laws. My name is Brad Huss and I am an attorney and a member of the law firm of Trucker Huss in San Francisco, California. Trucker Huss is one of the largest employee benefits specialty law firms in the country. Our firm provides services for a diverse array of retirement plans maintained by large and small corporate employers, union-management joint boards of trustees, state and local governments and non-profit entities. I personally have been practicing employee benefits law since 1977, when the Employee Retirement Income Security Act of 1974 (ERISA) became effective. I am the head of our firm's ERISA litigation department and my practice also includes counseling clients on the fiduciary responsibility rules of ERISA. I have been actively litigating ERISA cases for over twenty years and I have represented plan participants and beneficiaries as well as employers, plan fiduciaries and third party service providers.

I am also a member of the Board of Directors and a co-chair of the Government Affairs Committee of ASPA, on whose behalf I am testifying today. ASPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPA's membership is diverse, but united by a common dedication to the private pension system.

ASPA shares the concerns of this Committee, of the Congress, and of America about the tragic consequences arising from the bankruptcy of Enron. We applaud this Committee's leadership in exploring whether and how our nation's pension laws may need strengthening. We also commend the Committee for its stated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers. However, it is critically important that any legislative response to the Enron tragedy be carefully measured. We certainly do not want to impose rules that will result in reduced retirement plan coverage. In particular, we need to carefully consider any new burdens that may be imposed on small businesses that are already struggling to provide retirement benefits to their employees.

I would like to summarize ASPA's views on several issues concerning the fiduciary rules under ERISA in light of the problems concerning the Enron Corporation 401(k) plan. ERISA imposes fiduciary duties concerning the management of pension plans and provides for liability for breaches of those duties. These rules are fundamentally sound and have, in fact, been highly successful for over 25 years. One problem that does exist under ERISA is that plan participants have been restricted in their ability to obtain adequate individual relief for losses to their plan accounts caused by a fiduciary breach. ASPA believes that an amendment to ERISA may be appropriate in this regard. Care must be taken, however, that changes to ERISA do not discourage employers from maintaining pension plans.

Proposals have also been made to place time limits on, or prohibit, so-called "lockdowns" or "blackouts" during which plan participants cannot change their investment options. In the experience of ASPA members, lockdown periods are necessary to permit the orderly change of plan service providers, which is often done for the purpose of improving plan features for participants. ASPA believes that advance notice of lockdowns should absolutely be required, but opposes any unnecessary restrictions on the length of lockdowns. During a lockdown, ASPA does agree, as suggested by the Administration, that ERISA could be clarified to make clear that employers bear the fiduciary responsibility of monitoring investments when employees cannot. However, while it is appropriate to impose this responsibility on employers, the Administration also needs to provide guidance to employers, particularly small businesses, on how to comply with this responsibility so it does not become a trap for the unwary.

Another issue raised by the Enron situation is the investment of plan assets in the stock of the company sponsoring the plan, usually referred to as employer stock.

ASPA believes that employees should generally be provided with choice as to investing in employer stock. However, when providing choice, care must be taken to address the special concerns of small businesses whose stock is not publicly traded. Further, ASPA does have concerns about proposals to place artificial hard caps on the ability of individual participants to choose to invest in employer stock since such caps do not take into account the individual financial circumstances of each participant. For example, if an employee is covered by both a defined benefit plan and a defined contribution plan, investing a higher percentage of defined contribution assets into employer stock may be an entirely prudent investment decision due to the existence of the valuable and guaranteed defined benefit plan. Ultimately, the best protection for employees is a well-diversified investment portfolio. Consequently, employers need to be encouraged and protected in providing investment advice to plan participants. The legislation introduced by Senators Bingaman (D–NM) and Collins (R-Maine), if enacted, would effectively increase the access of plan participants to investment advice.

Finally, one of the most effective ways to strengthen the retirement security of American workers would be to revitalize the use of defined benefit plans that provide a guaranteed and insured benefit with the risk of plan investments being borne by the employer and not the employees.

AN OVERVIEW OF ERISA FIDUCIARY RESPONSIBILITY

ERISA currently provides for substantive rules of fiduciary duty and enforcement actions to redress fiduciary breaches. Establishing liability for a violation of the ERISA fiduciary responsibility rules requires a showing of: (i) fiduciary or co-fiduciary status, (ii) existence of a fiduciary duty, (iii) breach of the duty, and (iv) causation of damages. The key fiduciary provisions of ERISA are summarized below.

FIDUCIARY STATUS

ERISA provides that a person is a fiduciary with respect to a plan to the extent that he or she (i) exercises any discretionary authority or discretionary control respecting management of the plan; (ii) exercises any authority or control respecting management or disposition of its assets; (iii) renders investment advice for a fee or other compensation with respect to property and assets of the plan; or (iv) has any discretionary authority or discretionary responsibility in the administration of the plan. It is key that the definition of a fiduciary under ERISA is functional. Anyone who in fact exercises discretion or control over plan assets or plan administration may be held to be a fiduciary regardless of his or her nominal title or position. ERISA requires that every employee benefit plan provide for one or more named fiduciaries that shall have authority to control and manage the operation and administration of the plan.

FIDUCIARY DUTIES

ERISA requires that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries of the plan and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. ERISA further requires that a fiduciary act with the care, skill, prudence, and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Fiduciaries must also diversify the investments of the plan so as to minimize the risk of large losses and act in accordance with the documents and instruments governing the plan insofar as they are consistent with the provisions of ERISA. An exception to the diversification requirement is specifically provided for the holding of qualifying employer securities by eligible individual account plans, such as 401(k) plans.

LIABILITY FOR BREACH OF FIDUCIARY DUTY

Section 409(a) of ERISA provides that a fiduciary of a plan who breaches his or her fiduciary duty under ERISA shall be personally liable to make good to the plan any losses to the plan resulting from the breach. A breaching fiduciary also has to restore to the plan any profits that the fiduciary has made through the use of plan assets. A court may grant any other equitable or remedial relief, as the court deems appropriate, including removal of the fiduciary.

LIABILITY FOR BREACH BY A CO-FIDUCIARY

A plan fiduciary is liable for a breach of fiduciary responsibility by another plan fiduciary if (i) the fiduciary knowingly participates in, or knowingly undertakes to conceal, an act or omission of the other fiduciary while knowing that the act or omission is a breach; (ii) the fiduciary's failure to comply with his or her own specific fiduciary responsibilities has enabled the other fiduciary to commit a breach; or (iii) the fiduciary has knowledge of a breach by another fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.

SPECIAL FIDUCIARY RULES WHEN PARTICIPANTS CAN DIRECT INVESTMENTS

ERISA Section 404(c) provides fiduciary relief for plan sponsors or any other fiduciary of the plan when participants have the right to direct the investment of assets in their accounts. If the plan provides a sufficient array of investment options in accordance with Department of Labor regulations, all fiduciaries of the plan cannot be held liable for any losses, or by reason of any fiduciary breach, which results from participants' choices of investment options.

THE NEED FOR MEANINGFUL REMEDIES UNDER ERISA FOR PLAN PARTICIPANTS

ERISA imposes stringent fiduciary duties upon persons and entities responsible for the operation of employee benefit plans, particularly with respect to the proper management, administration and investment of plan assets. The Supreme Court has recognized that ERISA is a comprehensive statute designed to promote the interests of employees in their employee benefit plans. ERISA Section 2 states it is Congressional policy to provide plan participants with appropriate remedies, sanctions and ready access to the federal courts. However, the recent large loss of retirement benefits suffered by employees of Enron has highlighted the need for increased accountability for fiduciaries who administer employee benefit plans.

Despite the strong policy of ERISA to protect the retirement benefits of employees, Supreme Court decisions interpreting the enforcement provisions of ERISA have made effective remedies unavailable to individual plan participants who are seeking redress for a breach of fiduciary duty that has caused monetary or other legal damages to their plan benefits. Many lower court decisions have decried the lack of meaningful remedies under ERISA for individual plan participants, but have stated repeatedly that only Congress can solve this problem.

While the outcome of litigation over the Enron 401(k) plan remains to be seen, a recent case demonstrates the harm to innocent plan participants resulting from the lack of meaningful remedies under ERISA for individual participants who have been damaged by a fiduciary's breach of duty. In *Helfrich v. PNC Bank, Inc.*, 267 F.3d 477 (6th Cir. 2001), a participant in a 401(k) plan brought an action under ERISA against a plan trustee for breach of fiduciary duty. Mr. Helfrich was preparing for a distribution of his benefits and both the participant and the employer directed the plan trustee to transfer his account balance into certain mutual funds. The trustee, however, transferred the funds into a money market account instead. Mr. Helfrich brought a claim asking that the trustee compensate him for the losses he suffered because of the failure of the fiduciary to transfer his assets to the higher performing mutual funds in accordance with his instruction. The court, however, found that his requested remedy constituted money damages, not restitution, and the remedy was therefore unavailable to him under ERISA. The court noted that, while ERISA permits both plan participants and fiduciaries to sue to enforce its provisions, ERISA provides only a limited type of relief to plan participants. Although a plan fiduciary is entitled to seek the full gamut of legal and equitable relief, the courts have held that ERISA plan participants are restricted to equitable relief with no recourse to money damages. The courts have reached this restrictive result under ERISA even though, under the law of trusts, a traditional court of equity could award money damages in a lawsuit for a trustee's breach of fiduciary duty. A basic principle of trust law is that a beneficiary is entitled to a remedy that will put him in the position in which he would have been if the trustee had not committed the breach of trust.

As discussed above, ERISA Section 409(a) provides that a plan fiduciary who breaches his or her fiduciary duties under ERISA is personally liable to make good to the plan any losses to the plan resulting from the breach, and to restore to the plan any profits made by the fiduciary through use of plan assets. The fiduciary is also subject under ERISA Section 409 to other equitable or remedial relief, as the court deems appropriate. However, the Supreme Court in *Massachusetts Mutual Life Ins. Co. v. Russell* 473 U.S. 134 (1985) held that an individual plan participant cannot bring a claim for breach of fiduciary duty on behalf of himself under ERISA

Section 409, and its corollary provision Section 502(a)(2), because these provisions provide only for relief on behalf of the plan as a whole and not to individual participants. In Russell, the Court expressly reserved the question of whether ERISA Section 502(a)(3) allows individual claims for breach of fiduciary duty.

In *Varity Corp. v. Howe*, 516 U.S. 489 (1996), the Supreme Court later held that Section 502(a)(3) does provide individual plan participants with a cause of action for breach of fiduciary duty. The remedies provided by Section 502(a)(3), however, are much more limited than those provided under Section 409(a). ERISA Section 502(a)(3) provides that an action can be brought by a participant, beneficiary, or fiduciary to enjoin any act or practice which violates any provision of Title I of ERISA or the terms of the plan, or to obtain other appropriate equitable relief to redress such violations or to enforce any provisions of Title I or the terms of the plan. The Supreme Court, in *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993), specifically held that compensatory types of relief, i.e., monetary damages or legal relief, are not available in an action under Section 502(a)(3) as that section provides only for equitable relief.

ERISA was enacted to protect plan participants, particularly against the misuse of plan assets and breach of the fiduciary duty of loyalty. Restrictive Supreme Court interpretations of the enforcement provisions of ERISA have resulted in the frequent denial of meaningful remedies for individual plan participants who have been the victims of adjudicated fiduciary breaches, particularly with respect to monetary damages. ERISA needs to be amended to provide individual plan participants who have suffered losses from violations of the statute with effective remedies to make them whole and to adequately compensate their losses.

The most balanced approach to providing meaningful remedies for individual plan participants would be to amend ERISA Section 409(a) to specifically provide that individual plan participants and beneficiaries can bring actions against plan fiduciaries under Section 409(a) to obtain the remedies provided by that Section on their own behalf and not just on behalf of the plan as a whole. This legislative change would effectively overturn the decision of the Supreme Court in *Massachusetts Mutual Life Ins. Co. v. Russell*, as discussed above. Such an amendment would effectively increase accountability for fiduciary breaches under ERISA and would permit individual plan participants to recover compensatory damages for the loss of employee benefits in ERISA covered plans. This change would afford individual plan participants and beneficiaries the same broad range of remedies, including monetary damages, as are now available under ERISA Section 409(a) on behalf of a plan as a whole.

Some of the legislative proposals that have been quickly introduced in the wake of the Enron debacle would amend ERISA in a much more far-reaching manner and in a way that ultimately could be detrimental to the private retirement system. While the plight of the Enron employees has dramatically shown the need to make meaningful remedies available to plan participants under ERISA, care must be taken so that changes to the enforcement provisions of ERISA do not have the unintended effect of discouraging employers and plan sponsors from establishing and maintaining employee benefits plans. In particular, any amendments to ERISA should expressly state that punitive damages and consequential damages are not available in actions brought under ERISA. The need to provide meaningful remedies under ERISA must be properly balanced with the equally important need to expand pension coverage for American workers.

LOCKDOWNS PERIODS ARE NECESSARY FOR PLAN ADMINISTRATION

One issue being debated in the wake of Enron is whether the law should be amended to restrict so-called "lockdowns" of defined contribution plans. A lockdown, also called a "blackout" or "transaction suspension period," is a time during which plan participants may not direct certain transactions in their retirement plan accounts, such as transfers among investment options and participant loans, or receive final distributions.

Typically a lockdown is needed when an employer changes its pension plan service provider. It is analogous to changing ordinary checking accounts. Time is required for outstanding checks to clear, and for the new account to be set up. Similarly, accurate records cannot be compiled, transmitted, and set up by the new pension plan service provider if investment changes, loan activity and/or withdrawals are ongoing during the transfer. During such a lockdown period, participant records and plan assets must be reconciled before they are turned over to the new service provider, which must then set up the recordkeeping information for the plan on its own system. If participant records are in good order, the lockdown can often be less

than a week. However, it may take much longer, particularly for small business retirement plans where records may be more difficult to gather.

ASPA recently surveyed retirement plan administrators on their experiences with lockdowns. More than 250 firms responsible for administrating over 85,000 retirement plans that permit participants to direct the investment of their retirement accounts responded to the survey. On average, lockdowns for the plans surveyed lasted between three to four weeks. However, the survey indicated that lockdowns can last two months or even longer when records are difficult to gather. Finally, the survey showed that lockdowns are relatively infrequent and usually happen for a plan only once every three to four years.

Many times a lockdown is part of a process whereby a plan sponsor changes plan service providers in order to improve the investment alternatives or other plan features offered to plan participants. However, in response to the Enron bankruptcy, proposals have been made to limit the length of lockdowns or prohibit them altogether. ASPA believes these proposals are misplaced and would actually hurt plan participants. Such restrictions on lockdowns would be particularly inappropriate when a plan contains no employer stock, since there would be no opportunities for the type of manipulation, to the detriment of plan participants, that are alleged to have occurred in the Enron plan. ASPA, however, does believe that the law should be amended to require adequate notice and full disclosure to plan participants of impending lockdowns so that participants have the opportunity to make appropriate changes to their accounts in advance of a lockdown.

ASPA also agrees that, as has been suggested by the Administration, ERISA should be clarified to provide that employers have a fiduciary responsibility to monitor plan investments during a lockdown when participants are not permitted to change investment options. However, it is important to emphasize that such a proposal should not impose absolute liability for investment losses during a lockdown, such as investment losses due to typical market performance. Only when there is a fiduciary breach, should the employer be held liable. Further, it is critical that employers, particularly small businesses, be given clear guidance by the Administration on how to satisfy their fiduciary responsibilities during a lockdown. As noted earlier, lockdowns are often instituted when an employer is improving plan services for employees. Right now, because of the public controversy surrounding Enron, employers are reluctant to improve plan services for employees for fear of potential liability if they impose a lockdown. In order to give confidence to employers that they are complying with the law, guidance, including safe harbors, needs to be provided on what to do during a lockdown.

DIVERSIFICATION OF PLAN INVESTMENTS

Legislative proposals have already been introduced that would limit the percentage of plan assets that may be held in employer stock. Other proposals would require that plan participants be able to diversify their plan accounts out of employer stock after varying time periods. ASPA does believe it is appropriate to reexamine the rules regarding the ability of participants to diversify the investments in their individual accounts. However, ASPA is concerned about proposals to place artificial hard caps on the ability of individual participants to choose to invest in employer stock because such caps do not take into account the individual financial circumstances of each participant. For example, if an employee is covered by both a defined benefit plan and a defined contribution plan, investing a higher percentage of defined contribution assets into employer stock may be an entirely prudent investment decision due to the existence of the valuable and guaranteed defined benefit plan.

ASPA believes that plan participants should be able to exercise free choice as to investing their plan accounts in employer stock. Participants should be able to diversify their plan investments after a reasonable time, the length of which will vary depending upon the type of plan. However, it is important that any diversification requirements take into consideration the special concerns of small businesses. Small business stock is not publicly traded, and consequently, it requires significant expense to value such stock. Generally, ERISA requires small business stock to be valued once a year. Any proposals that would require more frequent valuations would be an undue burden on small businesses.

Diversification of investments is clearly the best protection against significant losses in retirement savings. ASPA believes that the best way to promote diversification and prevent an excessive concentration of employer stock in retirement accounts is to make it easier for employers to provide investment advice to plan participants. In this respect, ASPA supports the proposed Independent Investment Advice Act (S.1677) introduced by Senator Bingaman, of this committee, and Senator

Collins. According to surveys by the Profit-Sharing Council of America and the Institute of Management and Administration, the major reason employers do not currently provide investment advice to plan participants is concern about fiduciary liability. The Bingaman-Collins bill would provide employers with a safe harbor allowing them to satisfy their fiduciary obligations, thus facilitating the provision of investment advice to participants. In addition, ASPA recommends that the Department of Labor be directed to issue a model safe harbor notice to be distributed to participants that explains the advantages of diversification and the inherent risk of investing plan assets in employer stock.

STRENGTHENING THE PRIVATE PENSION SYSTEM

The current plight of the Enron 401(k) plan participants highlights the need to expand and reform the private pension system. This need is especially acute with respect to encouraging plan sponsors to adopt and provide defined benefit pension plans. Unlike 401(k) and other defined contribution plans, defined benefit plans provide a guaranteed retirement benefit for employees. Further, and very importantly, the employer, and not the employee, bears the risk of investing the assets of a defined benefit plan. In addition, the Pension Benefit Guaranty Corporation insures the payment of a minimum level of retirement benefits under a defined benefit plan. However, since the passage of ERISA, restrictive and complex laws have been enacted and complicated regulations issued which have seriously impeded the ability of large and small businesses alike to maintain defined benefit pension plans for their employees.

If Congress wants to provide greater retirement security for American workers, then it must do more than revise the fiduciary responsibility rules of ERISA. It is time to revitalize defined benefit plans and to once again make them attractive to both employers and employees.

On behalf of ASPA, I thank the Committee for the opportunity to present our views today. I would be glad to answer any questions that you may have.

PREPARED STATEMENT OF STEVEN A. KANDARIAN

Chairman Baucus, Senator Grassley, and Members of the Committee:

Good afternoon. I appreciate the opportunity to appear before you today. I became Executive Director of the PBGC on December 3, 2001, just three months ago, and look forward to working closely with this Committee.

My testimony this afternoon will address the Enron Corporation's defined benefit pension plans that are insured by the Pension Benefit Guaranty Corporation (PBGC).

PENSION BENEFIT GUARANTY CORPORATION

Background

I would like to take a few minutes to give you some background on the PBGC and its role in the pension system. PBGC was created by ERISA, the Employee Retirement Income Security Act of 1974, to guarantee private defined benefit pension plans that terminate without sufficient assets. Defined benefit plans provide a monthly retirement benefit, usually based on salary and years of service. The benefit amount does not depend on investment performance.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Pension and Welfare Benefits Administration (PWBA). Treasury and PWBA deal with both defined benefit plans and defined contribution plans, including 401(k) plans. PBGC deals only with defined benefit plans, and only to a limited extent, as guarantor of benefits in underfunded plans that terminate. PBGC has very limited regulatory or enforcement authority over ongoing plans; the authority PBGC does have relates to certain employer reporting requirements and to determining whether a plan should be terminated to protect the insurance program.

PBGC protects the benefits of about 44 million participants and beneficiaries in slightly more than 35,000 ongoing defined benefit pension plans. When a plan insured by PBGC terminates without sufficient assets, PBGC becomes trustee of the plan and pays plan benefits, subject to statutory limits. For the vast majority of participants in PBGC-trusteed plans, plan benefits are paid in full. Currently, PBGC is responsible for paying current or future benefits to about 624,000 people in terminated plans, with payments, for the first time, exceeding $1 billion in 2001.

PBGC is a wholly-owned federal government corporation. It operates under the guidance of a three-member Board of Directors—the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

PBGC receives no funds from general tax revenues. Operations are financed by insurance premiums set by Congress and paid by sponsors of defined benefit plans, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans. There is a two-part annual premium for single-employer plans—a flat-rate premium of $19 per plan participant plus a variable-rate premium of $9 per $1,000 of the plan's unfunded vested benefits. PBGC has a separate, smaller insurance program for multiemployer plans, which are collectively bargained plans maintained by two or more unrelated employers.

PBGC's statutory mandate is: (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants, (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under PBGC-insured plans, and (3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. PBGC strives to provide superior customer service to plan participants and premium payers.

Financial Condition of the PBGC

For its first 21 years, PBGC operated at a deficit, but gradually built up a surplus beginning in 1996 as a result of legislative reforms, a strong economy, good returns on investments, and no major terminations from 1996–2000. PBGC had a surplus of almost $10 billion in its single-employer program at the end of fiscal 2000 (September 30, 2000). At the end of fiscal 2001 (September 30, 2001), the surplus had dropped to approximately $7.7 billion. This year, we already know that PBGC will experience the largest claim in its history, in excess of $1 billion, when we become trustee of the LTV Steel pension plans. And we continue to face significant exposure from troubled companies with underfunded pension plans, especially in the steel, airline, and retail sectors.

Large plan terminations have always been, and continue to be, the single most important factor determining PBGC's workload as well as its financial condition. PBGC took in 104 plans with 89,000 participants last year, the largest number of participants in PBGC's 27-year history. We project about 180,000 new participants this year, more than double last year's record, as a result of the LTV Steel plans and other terminations.

PBGC'S EXPOSURE TO LOSS FROM ENRON PENSION PLANS

Mr. Chairman, you asked me to address PBGC's exposure to loss if the Enron pension plans terminate. Most of the public focus has been on Enron's 401(k) and employee stock ownership plans. These plans are not defined benefit plans and so are not insured by PBGC.

However, there are at least three defined benefit plans insured by PBGC in the Enron corporate group—the underfunded Enron Corporation Plan ("Enron Plan"), currently named the Enron Corporation Cash Balance Plan, and two others that are fully funded on a termination basis, based on the most recent actuarial information we have. The Enron corporate structure and history are complex, and we are still gathering information as to whether there are other defined benefit plans within the Enron corporate group. To date, PBGC has not taken over any Enron plans, but we are closely monitoring the situation.

PBGC estimates that the Enron Plan, with about 20,000 participants, has approximately $220 million in assets and is underfunded by at least $125 million on a PBGC termination basis. This estimate will change over time as a result of market movements in interest rates and asset performance. Of course, PBGC will not assume any pension obligations or sustain a loss if the Enron plans remain ongoing.

PBGC is sometimes asked why plan underfunding on a PBGC termination basis varies from what the plan has calculated on an ongoing plan basis. PBGC values pension obligations in terminated plans using actuarial assumptions designed to replicate the price of purchasing an annuity for the terminating plan in the private market. In contrast, companies are permitted to use assumptions appropriate for ongoing plans, within specified limits, to value their pension obligations for plan funding and financial reporting purposes.

One of the most significant actuarial assumptions is expected retirement age, which can change markedly at plan termination. Typically, employers sponsoring terminating plans are shutting down their operations. Employees who are eligible for unreduced (or partially reduced) early retirement benefits are more likely to retire early, thus increasing the plan's pension obligations. As a result of the dif-

ferences in actuarial assumptions for ongoing plans and terminating plans, a plan may be better funded when valued on an ongoing basis than on a termination basis.

ENRON CORPORATION DEFINED BENEFIT PENSION PLAN

The Enron Plan is currently a cash balance plan but has had a variety of benefit formulas in its history. The plan started out as a traditional final average pay plan, switched to an arrangement known as a "floor-offset Employee Stock Ownership Plan (ESOP)," which I will describe later, and finally became a cash balance plan. None of the changes in benefit formula affected benefits earned in prior years. Thus, a person who worked for Enron under all three arrangements has a defined benefit pension consisting of three separate components.

Final average pay plan (benefits earned before 1987). The Enron Retirement Plan was established on July 1, 1986. The plan was a successor of the InterNorth Corporation Plan ("InterNorth Plan"), which started in 1938, and the Houston Natural Gas Corporation Plan ("Houston Plan"), which was started in 1946. The InterNorth Plan, the Houston Plan, and the successor Enron Retirement Plan were "traditional" defined benefit plans. Benefits were calculated using employees' years of service and final average pay.

Immediately before the InterNorth Plan and Houston Plan merged to form the Enron Plan, the InterNorth Plan split into two plans: one for terminated vested participants and the other for retired and active participants and beneficiaries. Enron then closed out the InterNorth Plan for terminated vested participants, providing Enron a reversion of about $230 million in 1987.

Enron transferred the $230 million reversion to the Enron ESOP. The Enron ESOP was started in 1986 with a purchase of Enron stock, financed by a $335 million loan from Enron. The Enron ESOP used the $230 million reversion to partially repay the loan from Enron.

Floor-offset ESOP (benefits earned 1987–1994). Effective January 1, 1987, Enron amended the Enron Retirement Plan to have a floor-offset ESOP arrangement. The floor-offset arrangement did not affect benefits earned before 1987 or those earned after 1994 when the floor-offset arrangement was ended.

Under the floor-offset arrangement, the benefit computed under the final pay formula was "offset" by the benefit amount the ESOP account could provide. For example, consider a participant who began working for Enron during the years the floor-offset arrangement was in effect. Assume the participant's final pay formula benefit is $600 per month, and the ESOP is able to provide $400 per month at retirement. The participant would receive the ESOP account plus $200 per month from the defined benefit plan ($600 minus the $400 ESOP offset). As this example shows, the participant would receive a combined benefit that was never less than the benefit under the final pay formula ("the floor"). If the ESOP is able to provide more than $600 per month, the participant would receive the entire ESOP account but would not be entitled to a benefit from the defined benefit plan (because the $600 was fully offset by the ESOP).

Fixing of ESOP offset value and release of ESOP shares for non-retired participants. In1994, Enron froze the accrued benefits under the final pay formula (the floor) and also set up an arrangement to lock in the stock price of the ESOP offset over a five-year period. Each year for five years (1996–2000) the value of 20% of the ESOP stock (the offset) was fixed at the then current market value and the shares were released to the participants. The percentage was higher for those who were age 50 or older or retired. Future changes in the stock's value did not affect the part of the offset that had been fixed. PBGC is not aware of other ESOP offset plans that have fixed the value of the ESOP stock in computing the offset.

While we are still checking the details, it appears that after the Enron stock was released participants could sell it, if they wished, either at the time of the release or at monthly intervals in the future. Terminated vested and retired employees were given the choices of leaving the Enron stock in the ESOP (the default), receiving a distribution of the ESOP stock, transferring the shares to an IRA (where they could be sold), or using the proceeds of the sale of the ESOP stock to purchase an annuity from an insurance company. Active participants had the same options and, in addition, could transfer the stock to the Enron 401(k) plan, where the shares could be liquidated and the proceeds reinvested in other investments offered by the 401(k) plan.

Cash Balance formula (benefits earned after 1994). In 1996, the Enron Plan was amended to adopt a cash balance design. Accruals under the cash balance formula began on January 1, 1996, with an annual 5% salary credit and a monthly interest credit of the 10-Year Treasury rate from the preceding month. There were originally no accruals for 1995 in the plan, under either the old offset design or the cash bal-

ance design. The ESOP plan had incorporated a special allocation to compensate for this lack of accrual. This special allocation was made over two years. In addition, in 1997, an extra credit was applied to employees' cash balance accounts to make up for the smaller-than-expected special 1995 ESOP allocation.

Floor-Offset ESOPs

Enron's floor-offset arrangement is not common. The Omnibus Budget Reconciliation Act (OBRA) of 1987 generally banned ESOP offset arrangements in which more than 10% of the combined asset values of the defined benefit plan and the ESOP plan are invested in employer securities. However, OBRA contained a "grandfather" provision that permitted ESOP offset arrangements that were already in existence to remain in effect. Enron's floor-offset ESOP arrangement and those of about 150 other companies were permitted under the "grandfather" provision.

Thank you, Mr. Chairman. I would be pleased to answer questions from the Committee.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question 1: Defined benefit plans guarantee workers that they won't be left empty-handed when they retire. Yet over the years, defined benefit plans have been on the wane as more and more employers offer only defined contributions plans to their workers. I assume this concerns the PBGC a lot, since the fewer employers participate in the PBGC guarantee program, the higher the risk that any single company's failure will drain your fund of assets.

Has the PBGC identified the reasons for the drop in popularity of defined benefit plans? And, more importantly, do you have any suggestions for how we might reverse the trend?

Answer: There are several reasons for the shift from defined benefit plans to defined contribution plans. The reasons most often cited are:

(1) Employment has shifted from large, unionized, manufacturing sector companies, where defined benefit plans have predominated, to smaller companies in the service and other non-manufacturing sectors, where the predominant plans are defined contribution plans;

(2) Defined contribution plans are easier and less costly to administer, and the contribution requirements are more predictable and controllable;

(3) Many workers now see themselves as likely to change employers; these workers appreciate the pension portability inherent in defined contribution plans;

(4) Workers appreciate plans in which they see their balance grow and in which they have investment choices; and

(5) Employers' attitudes towards retirement benefits for their workers have changed from paternalism to favoring worker self-reliance, perhaps reflecting a more competitive economy and more mobile workers.

Department of Labor data on the percentage of wage and salary workers participating in defined benefit versus defined contribution plans show the extent of the shift to defined contribution plans:

Percentage of Wage and Salary Workers Participating In–

	Any Pension Plan	Defined Benefit Plan Only	Defined Contribution Plan Only	Both DB and DC Plans
1978	45%	27%	7%	11%
1997	46%	4%	25%	17%

Legislation enacted last year contains a number of incentives for employers to continue an existing defined benefit plan or establish one for the first time:

(1) An increase in the dollar limit on the annual benefit from a defined benefit plan, and elimination of the actuarial reduction in that limit for retirements on or after age 62.

(2) An increase in deductible contributions to a PBGC-insured plan, up to the amount of "termination liability," (but only in the year of plan termination).

(3) Acceleration of the phase-out of the so-called "full funding" limit on contributions to a defined benefit plan.

(4) Simpler and less stringent tests for determining whether a plan is "top-heavy." (Top-heavy plans are subject to a special vesting rules and minimum benefit accruals for "non-key" employees.)

It is too early to know the full impact of these incentives.

The Portman-Cardin bill contained additional incentives for defined benefit plans that had bi-partisan support and were non-controversial. Several of these provisions had been in EGGTRA but were dropped on jurisdictional grounds.

(1) Current law limits the amount that PBGC guarantees of the plan benefits of owners of 10% or more of a business. The provision would totally eliminate these limitations for all but those with 50% or more of the ownership interest. Owners who hold 50% or more of the company would be entitled to non-owner guarantees once the plan has been in existence for ten years (with a proportionately lower percentage for less than 10 years).

(2) Provide PBGC premium relief for new plans and small plans. Specifically:

(a) Giving new plans of small employers (100 or fewer employees) a reduced premium for the first 5 years—$5 (rather than $19) per participant, and no variable-rate premium.

(b) Phasing in the variable rate premium (currently $9 per $1,000 of underfunding), at the rate of 20% per year for new plans, to match the 20% phase-in of PBGC guarantees for new plans.

(c) Capping the variable rate premium for very small employers (25 or fewer employees) based on the number of employees.

We continue to study what can be done to encourage defined benefit plans.

Question 2: We've had a number of conversations with the other witnesses about the feasibility of creating a 'safety-net' or insurance program for defined contribution plans. The insurance concept would establish full protection for defined contribution plans, whereas a 'safety-net' concept would allow some level of losses to be sustained, but would protect against complete loss of principal. The PBGC spends a lot of it's time trying to make the federal insurance program for defined benefit plans work.

Do you have any thoughts on how we might provide some level of insurance for defined contribution plans?

Answer: There are several questions that should be addressed in designing an insurance program or safety net for defined contribution plans:

- What risk is being insured (i.e., general market risk, fraud, bankruptcy of the employer)?
- What conditions would there be on the insurance (e.g., period of coverage, coinsurance, ability to change investments)?
- Would the insurance be mandatory for all, mandatory for particular workers and/or retirees, or voluntary?
- Who would pay for the cost of the insurance, would there be subsidies and how would the cost affect the net return on the accounts?
- Can or should the private market provide the insurance (note: there are products currently on that market that provide guarantees)?
- What investment constraints would be necessary and how would the constraints affect the net return on the accounts?
- Is the program administrable?

Question 3: I'm very interested in the progression of the Enron defined benefit plan. As I understand your testimony, it started out as a traditional plan, was converted into a floor-offset arrangement, and ultimately converted again into a cash balance plan.

I'd like to focus for a minute on the floor-offset arrangement. Can you walk us through what the impact was on Enron's workers when the company fixed the value of the stock? Could workers lose their guaranteed benefits during this process?

Answer: In 1994, Enron froze benefits in the plan and set up a schedule to permanently fix the ESOP offset amount over a five-year period. One-fifth of the value of the Enron shares in the ESOP was fixed on January 15 of each year from 1996 through 2000. Thus, by January 15 of the year 2000, it was known how much a participant would receive from the defined benefit portion of the arrangement.

At the same points in time as when the offset amounts were fixed—that is, each January 15 over this 5-year period—the plan released control of these ESOP shares to the participants. The participants were then free to sell their Enron stock and purchase other investments.

For all participants who were at least age 50 and had 5 or more years of service on January 1, 1995, 100% of the shares in their ESOP retirement account were released to the participants' control as of January 15, 1996. For these participants, the ESOP offset amount was fixed based on the stock price on January 15, 1996.

Terminated vested and retired employees were given the choices of leaving the Enron stock in the ESOP (the default), receiving a distribution of the ESOP stock, transferring the shares to an IRA (where they could be sold), or using the proceeds of the sale of the ESOP stock to purchase an annuity from an insurance company. Active participants had the same options and, in addition, could transfer the stock

to the Enron 401(k) plan, where the shares could be liquidated and the proceeds reinvested in other investments offered by the 401(k) plan.

Impact on participants of fixing the offset and releasing the Enron shares. The impact on participants of fixing the offset and releasing the Enron shares depends on what participants did with the released stock and when.

It appears that election forms were made available in mid-November and were due by December 10th in order for a distribution to be made on January 15th. If a participant chose not to take a distribution of released shares, the window remained open with respect to those released shares on a monthly basis. Elections for distribution of previously released shares that are filed by the 20th of a month are made on the last day of that same month. Election forms filed after the 20th of a month are made on the last day of the following month.

As the table below illustrates, Enron stock was generally rising during the 5-year period in which the offset amounts was fixed and shares were released.

The price of Enron stock on each date the offset amounts were fixed and the shares released is shown in the following table:

Split-adjusted[1] closing price of Enron stock on each date offset amounts were fixed and shares released

Date	Price
January 15, 1996	$18.31
January 15, 1997	$22.19
January 15, 1998	$19.91
January 15, 1999	$31.91
January 14, 2000[2]	$56.38

[1] The only split during this time period was a 2-for-1 split effective July 23, 1999.

[2] January 15, 2000, was a Saturday.

Participants who sold the released shares at a higher price than was used to fix the offset, experienced a gain at the time of the sale. Participants who sold the shares at a lower price than was used to fix the offset or who never sold the stock, suffered losses. For those who sold shares and reinvested the proceeds, the overall result depends on the performance of the reinvested monies.

PBGC does not yet have information on what individual participants did with the released stock. We will be happy to provide the Committee with aggregate information when we obtain it.

Question 2: You mention in your testimony that there were originally about 150 other companies around the country whose floor-offset arrangements were grandfathered. Please provide the Committee with a list of the companies that still have active grandfathered floor-offset plans today and an estimate of how many workers are affected.

Answer: PBGC staff recall that there were about 150 companies with floor-offset ESOP arrangements that were plans that were grandfathered under the Omnibus Budget Reconciliation Act (OBRA) of 1987. Unfortunately, we have not been able to locate a list of the plans or companies. We are reviewing the Annual Reports (Form 5500) that employee benefit plans are required to file with the Department of Labor, IRS, and PBGC to see if we can identify companies that appear to have grandfathered floor-offset ESOP plans. We will provide our findings to the Committee.

Question 3: In addition to the grandfathered floor-offset arrangements there are other floor-offset plans that were not affected by the original limit of 10% of company stock. Do you have any estimate of how many of these plans exist today and how many workers they cover? Does the PBGC have any concerns about their stability?

Answer: PBGC currently does not maintain a list of floor-offset plans. We are reviewing the Annual Reports (Form 5500) that employee benefit plans are required to file with the Department of Labor, IRS, and PBGC to see if we can identify floor-offset plans. These plans do not pose any more risk than any defined benefit plan because they meet the 10% limit. They provide participants with a defined benefit floor that serves as a safety-net under their defined contribution plan benefit, as well as an upside if the defined contribution plan investments perform well. At the

same time, the 10% limit that applies to these plans provides protection for the PBGC if the plan terminates.

PREPARED STATEMENT OF WILLIAM F. SWEETNAM, JR.

Mr. Chairman, Senator Grassley and distinguished Members of the Committee, I thank you for the opportunity to testify before the Finance Committee on the important issue of retirement security—specifically, employer sponsored tax-qualified retirement savings plans, such as 401(k) plans.

My testimony this afternoon will address the President's Retirement Security Plan. As background, I will also address the current structure of the employer-provided retirement system as it is reflected in the Internal Revenue Code (the Code), especially plans that invest in company stock, and the expansions brought about by last year's Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The members of this Committee have always been serious proponents of the expansion of the retirement system. You, Mr. Chairman, Senator Grassley and Senator Graham have lead the way in promoting retirement legislation. Their efforts over the last few years resulted in retirement legislation that had overwhelming bipartisan support. Most of the provisions in their retirement bill were enacted last year as part of EGTRRA and we, at Treasury and the IRS, are working hard to make sure that these provisions have been implemented. There are many more members of this Committee who lead the way when it comes to expanding and protecting American retirement security. Senator Bingaman is one of those leaders by using his position on both this Committee and the Health, Education, labor and Pensions Committee. Senator Hatch is a long time advocate of increasing the number of pension plans for small businesses, especially by eliminating administrative complexity. Senator Breaux has been a great friend of employee stock ownership plans. And Senator Jeffords has always shown a great interest in retirement savings over the years.

The issues relating to promoting and protecting retirement savings can be difficult and the proper balances hard to strike. The substantial experience of this Committee will be a valuable asset.

In talking about retirement security and the defined contribution system, let us follow the path of bipartisanship that the Senate has been following when dealing with retirement issues. When looking at how to further improve the system, both sides having common goals. They include the promotion of the use of the voluntary, employer-based retirement system to provide retirement benefits to Americans and to protect participants' savings and retirement income. These laudable goals are reflected in all the various legislative proposals that have been introduced. Let us remember that we have the same goals when commencing this debate.

While the universal goal of the system is to provide for retirement security, each individual's personal goals for retirement savings differ. All agree that we must equip participants with tools to accomplish individual goals in a rational manner. Artificial restrictions may not be appropriate for all employees who are making personal decisions on how much to contribute to a plan and how to invest their contributions. Employees who determine their own investment goals do not want a government to restrict the amount of their investment that can be invested in specific funds.

Last month, President Bush formed a task force on retirement security. He asked Treasury Secretary O'Neill, Labor Secretary Chao and Commerce Secretary Evans to analyze our current pension rules and regulations and make recommendations to create new safeguards that protect the pensions of millions of American workers. In his State of the Union speech, the President reiterated this commitment when he said:

> "A good job should lead to security in retirement. I ask Congress to enact new safeguards for 401(k) and pension plans. Employees who have worked hard and saved all their lives should not have to risk losing everything if their company fails."

The President's Retirement Security Plan, announced on February 1, 2002, would strengthen workers' ability to manage their retirement funds by giving them freedom to diversify their investments and better information for making savings and investment decisions, including access to professional investment advice. It would ensure that senior executives are subject to the same restrictions as American workers during temporary blackout periods and that employers assume full fiduciary responsibility during such times. I will talk more about the specifics of his proposal later in my testimony.

Under our retirement system, no employer is obligated to provide a retirement plan for employees; the private retirement plan system is completely voluntary. There are clear benefits to employers who provide retirement plans not only tax benefits but also the benefits of hiring and retaining qualified employees who help the business prosper. Because of these benefits, we must be careful not to overburden the system. If costs and complexities of sponsoring a plan begin to outweigh advantages, employers will stop sponsoring plans. What benefit does an elaborate protection mechanism provide for retirement savings if the employer ceases sponsoring a plan? We should join together in a bipartisan fashion to ensure that the legislative proposals we advance will not result in a reduction in the number of employers' sponsoring plans.

An important point I would like to make is that the retirement system is thriving. Some statistics illustrate the strengths of the system.

- In 1998 (the most recent data available from the Department of Labor), qualified retirement plans for private employers covered a total of 41 million defined benefit plan participants and 58 million defined contribution plan participants. These plans held assets of $4 trillion. Contributions of $202 billion were made and benefits of $273 billion were paid.
- Currently, it is estimated that 42 million workers participate in 401(k) plans, which hold $2 trillion in assets (of which 19 percent are invested in employer securities). Employees contribute about $100 billion per year to 401(k) plans, and employers contribute another $50 billion per year. About half of 401(k) participants are also covered by another pension plan.

These statistics underscore the breadth of coverage of employer-sponsored plans and the strength and vitality of the 401(k) plan system. Other statistics, however, point out the lack of coverage in small business something that EGTRRA was designed to remedy.[1] In 1998, 86 percent of the employers with 500 or more employees sponsored a retirement plan. Fewer than 14 percent of the smallest employers sponsored a plan.

Tax Principles Regarding Retirement Plans and Company Stock

The importance of the retirement system under the tax code is long-standing. In the Revenue Act of 1921, Congress provided that contributions by an employer to a stock bonus or profit sharing plan[2] are deductible by the employer and not taxable until the amounts contributed are distributed or made available to the employee. Five years later, in the Revenue Act of 1926, the Congress extended this tax treatment to pension plans. The concepts of profit-sharing and stock bonus plans date back to the 1920's, and some of the oldest defined contribution plans now maintained by well-known and well-run companies began as stock bonus plans. Many companies that contribute stock to their retirement plans have employees who end up with very comfortable retirements. For example, the average rate of return from 1990 to 1997 for employee stock ownership plans was 13.3 percent, while for 401(k) plans it was 11.9 percent.

Some assert that having company stock in a retirement plan is a gamble that employees should not take. We believe that company stock, as part of one's overall retirement nest egg, has generally proven to be a favorable for employees. We all know examples of employees who did not fare well. While appropriate steps should be taken to enable employees to better protect themselves, we should not abandon the long-standing and successful employer-provided plan retirement system. Rather we should give employees more flexibility and more information so that they can better manage their retirement nest egg.

Tax qualified plans are accorded favorable tax treatment. A sponsoring employer is allowed a current tax deduction for plan contributions, subject to limits, and employees do not include contributions or earnings in gross income until distributed from the plan. Trust earnings accumulate tax-free.

Qualified plans are also subject to rules protecting participants and restricting the use of plan assets, including the following:

- Plan funds must be used only for the exclusive benefit of employees or their beneficiaries.

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[1] For example, EGTRRA provided a small business tax credit for new plan expenses for small businesses.

[2] A "profit sharing" plan is a tax qualified plan under which employer's contributions on behalf of covered employees are allocated according to a definite predetermined formula and distributed after a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. An employer does not have to have profits to make contributions to a profit sharing plan. A "stock bonus" plan is similar to a profit sharing plan, except that the contributions by the employer are distributable in stock of the employer.

- To ensure that employers provide benefits under these plans to moderate and lower-paid employees, qualified plans are subject to rules that prohibit discrimination in favor of highly compensated employees (the nondiscrimination rules).
- To encourage participants to keep amounts in plans to satisfy retirement needs, sanctions are imposed if funds are withdrawn from a qualified retirement plan prior to retirement.
- To ensure that plan assets are accumulated for retirement purposes and not accumulated as a death benefit, sanctions are imposed for not taking distributions during a participant's retirement years.

Since 1974, many of the tax qualification rules have also been addressed in provisions of the Employee Retirement Income Security Act of 1974 (ERISA).[3]

Types of Retirement Plans.

There are two broad categories of tax qualified retirement plans: defined benefit plans and defined contribution plans. While many of the tax rules regarding these types of plans are similar, there are important differences.

A defined benefit plan provides a participant with a benefit defined by the plan. The employer makes plan contributions that are actuarially determined to fund the benefit over the working life of the employee. The employee has no risk that his or her entire pension benefit will be lost. If the funds of the plan are insufficient to pay the benefits promised and the company is bankrupt, the Pension Benefit Guaranty Corporation provides a guarantee of benefits up to a statutory maximum, which in most cases exceeds the promised benefits. Conversely, if the investment experience of the underlying fund outpaces the promised benefits, the employer benefits through a lower contribution obligation. While excess funds are held for employees, they are not required to be used to increase pension benefits.

In a defined contribution plan, the employer makes a contribution that is allocated to participants' accounts under an allocation formula specified by the plan. Investment gains or losses increase or decrease the participant's account, without obligating the employer to make further contributions. Earnings increase the participant's ultimate retirement benefit; losses will decrease that ultimate benefit. Under a defined contribution plan the plan sponsor may, but is not required to, give participants the ability to allocate assets in their accounts among a number of investment alternatives. If a participant has the ability to direct plan investments, his or her investment decisions will determine the ultimate retirement benefit.

Due to a number of factors, there is a recent trend among employers to shift toward defined contribution plans. One of these factors has been the increasing mobility of the American workforce and demands by employees for a portable benefit. It is difficult for an employee who changes jobs frequently to vest in a significant defined benefit. From 1985 to 1998, the number of defined benefit plans fell by 67 percent and the number of active defined benefit participants fell by 21 percent. Over the same period, the number of defined contribution plans rose by 46 percent and the number of active defined contribution plan participants rose by 52 percent. In particular, the growth in the number of defined contribution plans and participants is due to an explosion in the number of 401(k) plans and participants.

Employees and employers both appreciate many of the advantages of defined contribution plans. Employees have become more mobile and defined contribution benefits are more valuable than defined benefits for employees who change employers during their working life. Employees also appreciate the ability to control the allocation of the assets in their accounts. Employers appreciate the more predictable funding obligations of defined contribution plans.

401(k) Plans.

A very popular feature in defined contribution plans is the cash or deferred arrangement, codified under section 401(k) of the Code (hence, the term "401(k) plan"). Section 401(k) of the Code permits a participant to elect to contribute, on a pre-tax basis, to a defined contribution plan instead of receiving cash compensation.

There are restrictions on these elective contributions, including a requirement that the average amount of elective contributions made by highly compensated em-

[3] For example, most of parts 2 and 3 of Title I of ERISA (the vesting, participation, and funding rules) are virtually identical to tax qualification rules in the Internal Revenue Code. The Internal Revenue Service makes determinations as to the qualified status of the form of a plan and audits whether plans operate in accordance with their terms. Generally, an employee cannot bring an action to enforce tax qualification requirements, which are enforced by the Internal Revenue Service. If a tax qualification requirement is also contained in ERISA, however, it can also be enforced by a plan participant or by the Department of Labor. The Reorganization Plan No. 4 of 1978 provides that, in general, the Secretary of the Treasury has the regulatory authority for those provisions that are contained in both the Internal Revenue Code and ERISA.

ployees (as a percentage of compensation) may not be greater than a certain percentage of the average amount of contributions made by non-highly compensated employees. This test is referred to as the Actual Deferral Percentage (ADP) test and must be satisfied annually. One result of the ADP test is that employers encourage participation by lower-paid employees. Employer matching contributions give an incentive to lower-paid employees to contribute to the plan. A new EGTRRA provision requires that matching contributions be 100 percent vested after three years of service or vested ratably over six years. Another important provision of EGTRRA, the Saver's Credit, provides a tax credit equal to 50 percent of the retirement savings (up to $2,000) of many lower paid employees. The more lower-paid employees save for retirement the more higher-paid employees can save.

Matching contributions are subject to a nondiscrimination test similar to the ADP test. This test, the Actual Contribution Percentage (ACP) test, is used to make sure that matching contributions do not disproportionately favor the highly compensated (as a percentage of compensation) relative to non-highly compensated employees. Prior to EGTRRA, an additional nondiscrimination test called the Multiple Use Test had to be passed. EGTRRA eliminated this third nondiscrimination test because it unnecessarily complicated 401(k) plan testing. Congress and the Administration agreed that the ADP and ACP tests are adequate to prevent discrimination in favor of highly compensated employees.

The ADP and ACP tests can be avoided through the use of one of two statutory safe harbors. Under one of the safe harbors, the employer matches 100 percent of an employee's contributions, up to 3 percent of compensation, and 50 percent of the employee's contributions between 3 percent and 5 percent of compensation. The other safe harbor requires the employer to make a contribution on behalf of all eligible employees (regardless of whether the employee actually makes a 401(k) contribution) equal to 3 percent of compensation.

Employee Stock Ownership Plans.

A stock bonus plan may be designated in whole or in part as an employee stock ownership plan, or ESOP. An ESOP is a plan that is designed to invest primarily in company stock. Currently, it is estimated that there are about 11,500 ESOPs, covering about 8.5 million workers. Only about nine percent of ESOPs are in publicly traded companies. However, these tend to be large companies and hence account for about half of ESOP-covered workers. In 1999, ESOPs held about $500 billion in assets and received $20 billion in contributions.

If a plan or a portion of a plan is an ESOP, the ESOP generally must pass voting rights on publicly traded stock held in participants' accounts to participants. An ESOP must give participants the right to request the distribution in stock, and, if the distribution is made in stock, the right to "put" (i.e., sell) the stock back to the company or the plan. In addition, participants who are age 55 and have at least 10 years of participation in the plan must be given the opportunity to diversify a portion of the stock held in their ESOP account.

Employers establish ESOPs for many reasons. In addition to providing retirement benefits to employees, an ESOP transfers employer stock to employees, thereby encouraging employee ownership and aligning employees' interests with the success of the company. An ESOP can be used to transfer ownership from a company founder to employees by having the ESOP borrow funds to purchase company stock as the owner retires or to provide additional capital for employer expansion. Tax-deductible ESOP contributions can be used by the ESOP to repay a loan. As the loan is repaid, the stock purchased with loan proceeds is allocated to participants. About three-quarters of ESOPs have used borrowed funds to acquire employer securities.

Another advantage to establishing an ESOP is the ability of the employer to deduct dividends paid on employer stock held in the plan. EGTRRA made this feature even more attractive by extending this deductibility feature to all ESOP dividends provided that participants are given the opportunity to elect to receive the dividend in cash. Because of the value of this expanded deduction for ESOP dividends, we understand that most publicly traded companies that have a non-ESOP employer stock fund will convert that stock fund to an ESOP and offer participants the opportunity to take a distribution of the dividend in cash.

When talking about ESOPs, many people refer to K–SOPs and M–SOPS. A K–SOP is an ESOP that uses an employee's 401(k) contributions to purchase employer stock or repay a loan whose proceeds had been used to purchase employer stock for the plan. Likewise, an M–SOP is an ESOP that uses the employer's matching contributions to purchase employer stock or repay an ESOP loan.

The President's Retirement Security Plan.

The President's plan puts employees in better control of amounts that they contribute to a 401(k) plan and improves employees' ability to make good individual investment decisions and reach their retirement goals. The President's plan focuses on the following four areas:

1. Giving Employees Investment Choice

The President believes that federal retirement policy should expand, not limit employee ability to invest their contributions or matching contributions as they see fit. Under the President's plan, employers cannot require that accounts of employees who have three or more years of participation in the plan be invested in employer stock. However, the employee is not required to diversify these amounts; it is the employee's choice. The three-year rule provides a balance between the employer's desire to have employees invested in employer stock and the employee's interests in diversification. The three-year period is consistent with the shorter vesting rule for employer matching contributions.

ESOPs are intended to be invested primarily in employer securities and are an accepted method of transferring ownership of a company to employees. Requiring diversification in all ESOPs would make it virtually impossible to accomplish the well-accepted purposes of an ESOP, including the encouragement of employee ownership and a source of financing to the employer. Moreover, ESOPs are subject to special diversification rules already in the Code. Therefore, the President's plan provides that a stand-alone ESOP (i.e., an ESOP that holds no 401(k) contributions, matching contributions, or other contributions used to satisfy the Code's nondiscrimination tests) will not be subject to these diversification requirements. K–SOPs and M–SOPs will be required to offer diversification rights to plan participants.

This new diversification requirement will be an addition to the overall tax qualification requirements under the Code. Since the diversification rule will be a tax qualification requirement, the plan document must specifically provide for the diversification right. If the diversification right is not contained in the plan, the IRS will refuse to issue a favorable determination letter stating that the plan meets the qualification requirements.[4] The diversification requirement would also be added to Title I of ERISA, thereby giving participants and the Department of Labor the ability to enforce the diversification right.

2. Clarifying Employers' Responsibilities During Blackout Periods and Creating Parity Between Senior Corporate Executive and Rank-and-File Workers

The President's plan provides fairness by eliminating double standards with respect to the ability to sell employer stock during the time plan recordkeepers or plan investments change—the so-called blackout period. This is accomplished by placing restrictions on corporate executives trading employer stock outside of a plan that parallel restrictions on employer stock transactions inside the plan during a blackout period. In addition to being fair to employees, this rule would create a strong incentive for corporate management to shorten the blackout period to the minimum time required to make changes.

Section 404(c) of ERISA provides employers with a defense against lawsuits when employers give workers control of their individual account investments. The President's plan would clarify ERISA to disallow employers from utilizing this 404(c) defense for fiduciary breaches that occur during a blackout period. Because the 404(c) defense is based on the premise that employers have given investment control to their workers, the defense logically is inappropriate during blackout periods when employers have suspended investment control from their workers.

3. Giving Employees Better Information about Their Pensions

To make sure that employees have maximum control over the investment of their retirement savings, the President's plan requires that notice be given to employees 30 days before the blackout period begins. With this notice, employees will be able to adjust investment selections in anticipation of the blackout period. Failure to provide this notice will result in a penalty on the plan sponsor of $100 per day per employee for every day that an employee did not get the notice.

The President also wants to make sure that employees get up-to-date information on plan investments and reminders of sound investment principles. The President's plan expands the current reporting requirements for 401(k)-type plans so that quarterly statements are required. In addition, the quarterly statement should address

[4] The IRS estimates that it will review approximately 120,000 plans during this year's filing season to determine whether they meet the qualification of the Code.

appropriate investment diversification. We believe that the more employees hear about diversification, the more they can decide for themselves whether their overall retirement savings are secure.

4. Expanding Workers' Access to Investment Advice

In order for employees to get the investment advice they need, the President advocates the enactment of the Retirement Security Advice Act which passed the House with overwhelming bipartisan support. Currently, ERISA impedes employers from obtaining investment advice for their employees from the financial institutions that often are in the best position to provide advice. The Retirement Security Advice Act would address this by providing employees with access to advice from fiduciary advisers that are regulated by Federal or State authorities. As fiduciaries, these advisers would be held to the standard of conduct currently required by ERISA. This legislation encourages employers to make investment advice more widely available to workers and only allows qualified financial advisors to offer advice if they agree to act solely in the interests of employees. The Retirement Security Advice Act would also add important protections by requiring information about fees, relationships that may raise potential conflicts of interest, and limitations on the scope of advice to be provided. The legislation also would place advisers who have affiliations with investment products on a more equal footing with non-affiliated advisers, foster competition among firms, and promote lower costs to participants.

I reiterate the Administration's desire to achieve consensus on both the problems and solutions surrounding the retirement security of all Americans. I hope that we can work together to improve the employer-based retirement system and provide more retirement security for all Americans by providing more investment choice, plan information, and investment education to employees.

I appreciate the opportunity to discuss these important issues with the Members of this Committee, and would be pleased to explore these issues further.

Mr. Chairman, this concludes my formal statement. I will be pleased to answer any questions you or other Members may wish to ask.

PREPARED STATEMENT OF JACK L. VANDERHEI*

RETIREMENT SECURITY AND DEFINED CONTRIBUTION PENSION PLANS: THE ROLE OF COMPANY STOCK IN 401(k) PLANS [1]

1 Introduction

Chairman Baucus, Ranking Member Grassley, members of the committee. I am Jack VanDerhei, a faculty member in the risk insurance and health care management at the Fox School of Business, Temple University, and research director of the Employee Benefit Research Institute Fellows Program.

1.1 Objectives of the Testimony

My testimony today will focus on retirement security and defined contribution pension plans with special emphasis on 401(k) plans with company stock. This draws on the extensive research conducted by the Employee Benefit Research Institute and on the EBRI/ICI 401(k) database. Portions of this testimony borrow heavily from a recent publication I co-authored with Sarah Holden of the Investment Company Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," *EBRI Issue Brief*, November 2001.

2 Defined Benefit/Defined Contribution Trends

More than a quarter-century ago, Congress enacted the landmark law that still governs employment-based retirement plans in the United States. The Employee Retirement Income Security Act of 1974 (ERISA), after more than two decades of amendments and regulatory embellishments, remains the basis of the federal government's approach to retirement plan regulation. Widely praised for achieving its goal of greater retirement security for those American workers who have pensions, it is simultaneously criticized for contributing to the demise of the traditional defined benefit corporate pensions that it was created to secure and encourage. The number of these traditional pension plans has sharply declined, while new forms of defined benefit plans have increased their position of dominance.[2] These new plans include cash balance plans,[3] which are technically defined benefit plans but are

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*The views expressed in this statement are solely those of Jack VanDerhei and should not be attributed to Temple University or the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

often more readily understood by employees as a result of their use of "individual accounts" and "lump-sum distributions," and defined contribution plans, which are typified by the 401(k).

The decline in traditional defined benefit plans has been well-documented and is continuing.[4] Several reasons for the decline of defined benefit plans have been suggested: the change in the industrial patterns of employment in America favoring the small service industry; administrative costs of operating defined benefit plans, which have been especially burdensome for small and medium-size plans; competition from 401(k) salary deferral plans, which are easier for employees to understand and which came along just as the cost and complexity of defined benefit plans began to skyrocket; and tax policy that has restricted funding of defined benefit plans.

2.1 The Relative growth of Defined Contribution Plans From 1978 to 1997[5]

In 1978, the first year detailed data were collected after ERISA, there was a total of 442,998 private pension plans, 29 percent of which were of the defined benefit variety. By 1997, the most recent year for which detailed data are available, the number of plans had increased to 720,041 but the relative share of defined benefit plans had decreased to 8 percent. Even though defined benefit plans have always been in the minority, they tend to be sponsored by large employers and accounted for 65 percent of the 44.7 million active participants in 1978. The number of active participants increased to 70.7 million in 1997, but the relative share of defined benefit plans fell to 32 percent.

A total of $377 billion of private pension assets existed in 1978. This number grew to $3.55 billion in the following 20 years. Although defined benefit plans represented 72 percent of the total in 1978, it fell to only 49 percent in 1997. If the latest numbers are any indication, it would appear that this financial trend will not reverse any time soon. In 1978, net contributions (the difference between contributions and benefits disbursed) amounted to $29.4 billion for all private plans, and 68 percent of this was from defined benefit plans. By 1997, net contributions had fallen to a negative $54.5 billion. Although defined contribution plans contributed a positive $12.8 billion, defined benefit plans had a negative net contribution of $67.4 billion.[6]

2.2 The Increasing Importance Of Defined Contribution Plans For Family Retirement Security

Although the preceding section documented the increasing importance of defined contribution plans with respect to plan aggregate data, for purposes of this testimony it may be even more important to consider how the relative value of these plans has changed from the standpoint of the family's retirement security. Craig Copeland and I[7] analyzed data from the Federal Reserve Board's triennial Survey of Consumer Finances (SCF), which provides the most comprehensive data available on the wealth of American households. We tracked information from the 1992, 1995, and 1998 (the most recent data currently available) surveys and found the following:

- The percentage of families with a pension plan who have defined benefit coverage has decreased from 62.5 percent in 1992 to 43.1 percent in 1998, and the significance of 401(k)-type plans for those families participating in a pension plan more than doubled, from 31.6 percent in 1992 to 64.3 percent in 1998.
- The percentage of family heads eligible to participate in a defined contribution plan who did so increased from 73.8 percent in 1995 to 77.3 percent in 1998. Of those families choosing not to participate in a defined contribution plan, 40.3 percent were already participating in a defined benefit plan.
- Overall, "personal account plans" represented nearly one-half (49.5 percent) of all the financial assets for those families with a defined contribution plan account, IRA, or Keogh, in 1998. This was a significant increase from 43.6 percent in 1992. The average total account balance in personal account plans for families with a plan in 1998 was $78,417, an increase of 54 percent in real terms over the 1992 balance of $50,914 (expressed in 1998 dollars).

2.3 Size And Importance of 401(k) Plans

Profit-sharing plans with cash or deferred arrangements (more commonly referred to as 401(k) plans) grew in number from virtually no plans in 1983[8] to 265,251 by 1997 (the most recent year for which government data are currently available), accounting for 37% of qualified private retirement plans, 48% of active employees, and 65% of new contributions.[9]

As of 1997, the most recent year for which published government data are currently available, there were 265,251 401(k)-type plans with 34 million active participants holding $1.26 trillion in assets. Contributions for that year amounted to $115 billion, and $93 billion in benefits were distributed.[10] By year-end 2000, it was estimated that approximately 42 million American workers held 401(k) plan accounts, with a total of $1.8 trillion in assets.[11]

2.4 What Will The Future Hold?

While it is impossible to predict with certainty how future developments for legislative and regulatory constraints and opportunities as well as plan sponsor and participant decisions will translate into future defined benefit/defined contribution trends, Craig Copeland of EBRI and I modeled the likely financial consequences of continuing the status quo. Our preliminary findings [12] from the EBRI/ERF Retirement Income Projection Model were presented at the National Academy of Social Insurance 13th Annual Conference on The Future of Social Insurance: Incremental Action or Fundamental Reform?

Results of the model are compared by gender for cohorts born between 1936 and 1964 in order to estimate the percentage of retirees' retirement wealth that will be derived from DB plans versus DC plans and IRAs over the next three decades. Under the model's baseline assumptions, both males and females are found to have an appreciable drop in the percentage of private retirement income that is attributable to defined benefit plans (other than cash balance plans). In addition, results show a clear increase in the income retirees will receive that will have to be managed by the retiree. This makes the risk of longevity more central to retirees' expenditure decisions.

3 Background on Company Stock

Although the topic of company stock investment in 401(k) plans has recently been the focus of considerable interest, the concept of preferred status for employee ownership has been part of the U.S. tax code for more than 80 years.[13] When the ERISA was passed in 1974, it required fiduciaries to diversify plan investments for defined benefit plans and some types of defined contribution plans. However, ERISA includes an exception for "eligible individual account plans" that invest in "qualifying employer securities."[14] An Employee Stock Ownership Plan (ESOP) normally qualifies for this exception, as do profit-sharing plans.[15]

The concept of legislating diversification for qualified retirement plan investments in company stock was first applied to ESOPs via a provision enacted as part of the Tax Reform Act of 1986.[16] Employees who are at least age 55 and who have completed at least 10 years of participation must be given the opportunity to diversify their investments by transferring from the employer stock fund to one or more of three other investment funds.[17] The right to diversify need be granted only for a 90-day window period following the close of the plan year in which the employee first becomes eligible to diversify and following the close of each of the next five plan years. This right is limited to shares acquired after 1986 [18] and is further limited to 25% of such shares until the last window period, when up to 50% of such shares may be eligible for diversification.

The Taxpayer Relief Act of 1997 applied a limit on mandatory investment of 401(k) contributions in employer stock. This was a more modest version of a proposal by Sen. Barbara Boxer (D–CA) to impose a separate limitation of 10% of plan assets on the mandatory investment of 401(k) contributions in qualifying employer stock and real property.[19]

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the dividend deduction for ESOPs to include dividends paid on qualifying employer securities held by an ESOP that, at the election of participants or beneficiaries, are: 1) payable directly in cash; 2) paid to the plan and distributed in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan; or 3) paid to the plan and reinvested in qualifying employer securities.[20] A 401(k) plan with a company stock fund that regularly pays dividends may consider designating a portion of the plan that includes the company stock fund to be an ESOP in order to take advantage of this deduction.[21]

At Enron, 57.73% of 401(k) plan assets were invested in company stock, which fell in value by 98.8% during 2001.[22] The decrease in share price and eventual bankruptcy filing of Enron resulted in huge financial losses for many of its 401(k) participants. This has prompted several lawsuits as well as congressional and agency investigations into the relative benefits and limitations of the current practice. In addition, the practice of imposing "blackout" periods when the 401(k) sponsor changes administrators has recently been called into question in light of the Enron situation.[23]

Certainly, the Enron situation has caused the retirement income policy community to focus increased attention to the desirability of current law and practices regarding company stock in 401(k) plans, resulting in much debate. Presumably, any recommendations to modify current pension law would attempt to strike a balance between protecting employees and not deterring employers from offering employer matches to 401(k) plans. Some have argued that if Congress were to regulate 401(k) plans too heavily, plan sponsors might choose to decrease employer contributions or

not offer them at all. Previous research[24] has shown that the availability and level of a company match is a primary impetus for at least some employees to make contributions to their 401(k) account. Others have argued that individuals should have the right to invest their money as they see fit.

4 The Concentration of Company Stock In 401(k) Plans

4.1 Percentage of 401(k) Plans and Participants With Company Stock

In Figure 1 of my February 13, 2002, hearing testimony before the House Education and Workforce Committee's Subcommittee on Employer-Employee Relations,[25] I show that for the 1996 version[26] of the EBRI/ICI database, only 2.9% of the 401(k) plans included company stock (1.4% of the plans had company stock but no guaranteed investment contracts (GICs)[27] while 1.5% of the plans had both company stock and GICs). However, the plans that do have company stock are generally quite large and represented 42% of the 401(k) participants in the database that year (17% of the participants had company stock but no GICS, while 25% had both options).[28] In terms of account balances, plans with company stock account for 59% of the universe (23% of the assets were held in plans that had company stock but no GICS, while 36% of the assets were held in plans that had both options).[29] The fact that plans with company stock had higher average account balances was no doubt partially due to the bull market preceding this time period, but may also be a function of the plan's generosity parameters and average tenure of the employees.

4.2 Company Stock as a Percentage of Total 401(k) Balances

The overall percentage of 401(k) account balances in company stock has remained consistently in the 18–19% range from 1996 to 2000.[30] The age distribution for year-end 2000 is somewhat of an inverted "U" shape, with younger and older participants holding slightly less than participants in their 40s (where the value peaks at 19.7%).[31]

Although often quoted, this figure is somewhat misleading given that a sizeable percentage of the 401(k) participants are in small plans that do not generally include company stock in the investment menu. The average asset allocation in company stock is:[32]

- Less than 1% for plans with fewer than 500 participants,
- 3.8% for plans with 501–1,000 participants,
- 8.7% for plans with 1,001–5000 participants, and
- 25.6% for plans with more than 5,000 participants.

When only plans that include company stock are analyzed, plans that offer company stock but not GICs have an average of 31.8% of the account balances invested in company stock, while the figure decreases to 27.7% for plans that also include GICs. Once the influence of the investment menu is controlled for, the impact of plan size is less significant.[33]

I also illustrate the impact of salary on company stock allocation for the subset of the EBRI/ICI database for which we have the requisite information.[34] For plans both with and without GICs, there appears to be an inverse relationship between the level of salary and the percentage of 401(k) balance invested in GICs, although the relationship is much less significant in the former case. The extent to which this is due to non-participant-directed matching contributions making up a larger percentage of annual contributions for lower-paid individuals awaits further investigation.[35]

4.3 Distribution of Company Stock Allocations

Several legislative proposals have called for an absolute upper limit on the percentage of company stock that an employee will be allowed to hold in his or her 401(k) account. Figure 8 of my February 13th testimony provides the year-end 2000 company stock allocation for the EBRI/ICI universe of plans offering company stock. A total of 48% of the 401(k) participants under age 40 in these plans have more than 20% of their account balances invested in company stock. The percentage decreases to 47% for participants in their 40s, 45% for those in their 50s and drops to 41% for participants in their 60s.

5 Employee Reaction When Employers Mandate That Matching Contributions Be Invested in Company Stock

Typically, in a 401(k) plan, an employee contributes a portion of his or her salary to a plan account and determines how the assets in the account are invested, choosing among investment options made available by the plan sponsor (employer). In many plans, the employer also makes a contribution to the participant's account, generally matching a portion of the employee's contribution. Some employers require that the employer contribution be invested in company stock rather than as directed

by the participant.[36] Participants in these plans tend to invest a higher percentage of their self-directed balances in company stock than participants in plans without an employer-directed contribution. Company stock represents 33% of the participant-directed account balances in plans with employer-directed contributions,[37] compared with 22% of account balances in plans offering company stock as an investment option but not requiring that employer contributions be invested in company stock.[38]

When total account balances are considered, the overall exposure to equity securities through company stock and pooled investments is significantly higher for participants in plans with employer-directed contributions. For example, investments in company stock, equity funds, and the equity portion of balanced funds represent 82% of the total account balances for participants in plans with employer-directed contributions, compared with 74% of the total account balances for participants in plans without employer-directed contributions. This higher allocation to equity securities holds across all age groups.

6 What Would Happen to Employees If Company Stock Were Not Permitted in 401(k) Plans?

Well before the plight of Enron 401(k) participants had made the headlines, personal finance and investment advisors had long touted the benefits of diversification.[39] While the trade-off of a diversified portfolio of equities for an individual stock may be of limited advantage for employees, what many of the commentators in this field have disregarded is the potentially beneficial attendant shift in asset allocation resulting from the inclusion and/or mandate of company stock, especially for young employees, who otherwise exhibit extremely risk-averse behavior in the determination of equity concentration for their 401(k) portfolio.

What I will attempt to demonstrate in the following section is that although forcing the employer match into company stock obviously increases the standard deviation of expected results relative to a diversified equity portfolio, for each of the last five years the EBRI/ICI data base has demonstrated that, left to their own choices, the employee's asset allocation would have lower concentrations in equity (defined as diversified equity plus company stock plus 60% in balanced funds) and therefore have a lower expected rate of return.

In my February 13th testimony, I start with some stylized examples of how the inclusion of company stock may work to the benefit of employees in general and expand the analysis by simulating the expected change in 401(k) account balances if company stock were prospectively eliminated from 401(k) plans for birth cohorts from 1936–1970. These results may be useful in analyzing previous charges that company stock should not be used in tax-subsidized accounts. In an attempt to assess the first-order impact of eliminating company stock in 401(k) plans, I programmed a new subroutine to the EBRI/ERF Retirement Income Projection Model to simulate the financial impact on 401(k) account balance.[40]

6.1 Simulation Results

The simulation was performed for birth cohorts between 1936 and 1970, and the results indicate the overall gain or loss from (prospective) retention of company stock in 401(k) plans (as opposed to company stock being entirely eliminated immediately). The estimated gain of retaining company stock is 4.0% of 401(k) balances, assuming complete independence with respect to the probability of company stock in a subsequent plan and 7.8% assuming perfect correlation.

Figure 1 (below) provides the results of the simulation by gender and preretirement income, assuming complete independence.[41] Preretirement income was categorized as either high or low by simulating the income in the year prior to retirement and comparing it with the median income for participants in the same birth cohort. Males would gain more than females from retention of company stock for both levels of relative salary. Participants in the lower relative salary levels would stand to gain more than their higher paid counterparts for both genders.

Figure 1

Average Gain From Retention of Company Stock as a Percentage of 401(k) Balance, By Gender and Relative Pre-retirement Salary (Assuming Complete Independence)

Preretirement salary relative to median for age cohort	Gender	
	Male	Female
Low	5.2%	3.5%
High	5.0%	1.6%

Source: Simulations using the EBRI/ERF Retirement Income Projection Model with modifications as described in author's February 13, 2002, written testimony to the House Education and Workforce Committee's Subcommittee on Employer-Employee Relations.

7 What Would Happen If a Minimum Rate of Return Were Guaranteed for 401(k) Participants?

Proposals have been suggested recently that would attempt to transfer part or all of the investment risk inherent in defined contribution plans from the employee to another entity. Although the party initially exposed to said risk varies among the proposals, the likely targets would be the employer, a government agency (perhaps the Pension Benefit Guaranty Corporation) and/or a private insurance company. While the cost of the guarantees and/or financial uncertainty inherent in such an arrangement may be borne by the employer at least initially, it is unlikely that, in the long-term, such a shift in risk-bearing would not somehow alter the provisions of the existing defined contribution plans.

It is obviously impossible to model the financial consequences of such proposals until additional detail is provided; however, a highly stylized example of one method of achieving this objective can be readily simulated. Assume a proposal that would require the employer to ensure that participants receive an account balance no less than what would have been obtained under a minimum rate of return. While some employers may choose to voluntarily assume the additional cost of this arrangement, others may wish to re-think the investment options provided to the employees and provide little or no participant direction. In fact, an easy way of mitigating the new risk imposed by the minimum guarantee would be to force all contributions (whether contributed by the employee or the employer) into a relatively risk-free investment. While this is unlikely to be popular with young employees and other participants desiring high long-term expected returns, it would minimize the new risks shifted to the employer.

Figure 2 shows the expected results of running one such proposal through the EBRI/ERF Retirement Income Projection Model. Instead of allowing employees to direct their own contributions and perhaps those of the employer, assume employers are forced to guarantee a minimum rate of return of five percent nominal and they are able to find a GIC (or its synthetic equivalent) that will provide that return in perpetuity.[42] If all existing balances and future 401(k) contributions were required to be invested in this single investment option, the average expected reduction in 401(k) account balances at retirement would decrease between 25 and 35 percent for participants born between 1956 and 1970.[43]

While the results in Figure 2 are specific to the assumptions mentioned above, similar results are obtained (albeit with different percentage losses) under various combinations of minimum guarantees and assumed asset allocations and rates of return.

Endnotes

[1] Portions of this testimony borrow heavily from Sarah Holden and Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000," *EBRI Issue Brief* n. 239, November 2001.

[2] "The Future of Private Retirement Plans," Dallas Salisbury, ed. EBRI Education and Research Fund (Employee Benefit Research Institute, 2000)

[3] See Jack VanDerhei, "The Controversy of Traditional vs. Cash Balance Plans." *ACA Journal*, Vol. 8, no. 4 (Fourth Quarter 1999): 7 16.

[4] For a detailed analysis of these trends from 1985 to 1993, see Kelly Olsen and Jack VanDerhei, "Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going," *EBRI Special Report* SR–33 and *EBRI Issue Brief* no. 190 (Employee Benefit Research Institute, October 1997).

[5] U.S. Department of Labor, Pension and Welfare Benefits Administration. "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10* (Winter 2001).

[6] The rate of return generated by these plans also needs to be considered for a complete analysis of the relative financial cash flow.

[7] Craig Copeland and Jack VanDerhei, "Personal Account Retirement Plans: An Analysis of the Survey of Consumer Finances," *EBRI Issue Brief* no. 223 (Employee Benefit Research Institute, July 2000).

[8] Although cash or deferred arrangements have existed since the 1950's, the Revenue Act of 1978 enacted permanent provisions governing them by adding Sec. 401(k) to the Internal Revenue Code. While this was effective for plan years beginning after 1979, the proposed regulations were not released until November 1981. See Jack VanDerhei and Kelly Olsen, "Section 401(k) Plans (Cash or Deferred Arrangements) and Thrift Plans," *Handbook of Employee Benefits*, 5th Ed., Jerry S. Rosenbloom, ed. (Homewood, IL: Dow Jones-Irwin, 2001).

[9] U.S. Department of Labor, Pension and Welfare Benefits Administration. "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10* (Winter 2001). For a review of the academic literature analyzing these trends, see William Gale, Leslie Papke, and Jack VanDerhei, "Understanding the Shift Toward Defined Contribution Plans," in *A Framework For Evaluating Pension Reform* (Brookings Institution/TIAACREF/ Stanford University), forthcoming. (*www.brook.edu/es/erisa/99papers/erisa2.pdf*)

[10] U.S. Department of Labor, Pension and Welfare Benefits Administration, "Abstract of 1997 Form 5500 Annual Reports," *Private Pension Plan Bulletin No. 10* (Winter 2001).

[11] Holden and VanDerhei (November, 2001), p. 3.

[12] The results were generated prior to the contribution modifications enacted as part of The Economic Growth and Tax Relief Reconciliation Act of 2001" (EGTRRA). The model is currently being modified to allow for the new EGTRRA provisions.

[13] The first stock bonus plans were granted tax-exempt status under the Revenue Act of 1921. See Robert W. Smiley, Jr. and Gregory K. Brown, "Employee Stock Ownership Plans (ESOPs)," *Handbook of Employee Benefits*. 5th Ed., Jerry S. Rosenbloom, ed. (Homewood, IL: Dow Jones-Irwin, 2001).

[14] ERISA Sec. 407(b)(1).

[15] This is important because an ESOP is to be "primarily invested" in qualifying employer securities. See "Employee Stock Ownership Plans (Part II)," *Journal of Pension Planning and Compliance* (Winter 2000); John L. Utz; pages 1–34.

[16] It should be noted that less than 5% of all ESOPs are in public companies. For an explanation of the challenges that stricter diversification rules may present to private company ESOPs, see Corey Rosen, "Should ESOPs Be Subject to Stricter Diversification Rules?" (*www.nceo.org/library/boxer—corzine—bill.html*)

[17] Alternatively, amounts subject to the right of diversification may be distributed from the plan. See Everett T. Allen, Jr., Joseph J. Melone, Jerry S. Rosenbloom and Jack L. VanDerhei, *Pension Planning: Pensions, Profit Sharing, and Other Deferred Compensation Plans* (8th ed) (Homewood, IL: Richard D. Irwin, Inc., 1997).

[18] As a result, the impact of this change was de minimis during the significant market decline in the fall of 1997. See Jack VanDerhei, "The Impact of the October 1987 Stock Market Decline on Pension Plans," written testimony for U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight, July 1988.

[19] The final version exempts from the 10% limits: (1) *de minimis* (i.e., as much as 1% of pay) mandatory investment provisions, (2) plan designs under which the Sec. 401(k) deferrals (regardless of amount) are part of an ESOP, and (3) plans in which the total assets of all defined contribution plans of the employer are not more than 10% of the total defined benefit and defined contribution plan assets of the employer. The limit applies prospectively with respect to acquisitions of employer stock. The investment of matching or other employer contributions continues to be exempt from any limits. See Louis T. Mazawey, "1997 Tax Law Changes Affecting Retirement Plans," *Journal of Pension Planning and Compliance* (Winter 1998): 72–86. For more detail on the original proposal, see Ann L Combs, "Taking Stock of the Boxer Bill," *Financial Executive* (Jan./Feb. 1997): 18–20.

[20] Hewitt, *Special Report to Clients*, July 2001, "Impact of EGTRRA on Employer Plans." www.hewitt.com/hewitt/resource/wsr/2001/egtrra.pdf)

[21] Watson Wyatt Worldwide, "Retirement Plan Provisions: What, When and How Much?" (Washington, DC: Watson Wyatt Worldwide, 2001).

[22] "Enron Debacle Will Force Clean Up of Company Stock Use in DC Plans," *IOMA's DC Plan Investing*, Dec. 11, 2001, p. 1.

[23] Currently, there is no statutory or regulatory limit on the length of time during which participants can be blocked from reallocating assets or conducting other transactions in a 401(k) plan. See Patrick J. Purcell, "The Enron Bankruptcy and Employer Stock in Retirement Plans," *CRS Report for Congress* (Jan. 22, 2002): 5.

[24] Jack VanDerhei and Craig Copeland, "A Behavioral Model for Predicting Employee Contributions to 401(k) Plans," *North American Actuarial Journal* (First Quarter, 2001).

[25] See Jack L. VanDerhei, "The Role of Company Stock in 401(k) Plans," hearing testimony before the House Education and Workforce Committee Subcommittee on Employer-Employee Relations, "Enron and Beyond: Enhancing Worker Retirement Security," Feb. 13, 2002.

[26] Readers should be cautioned that while the EBRI/ICI database appears to be very representative of the estimated universe of 401(k) plans, there has currently been no attempt to develop extrapolation weights to match up these plans with those reported on the Form 5500. See Holden and VanDerhei (November 2001), p. 6 for more detail.

[27] Guaranteed investment contracts (GICs) are insurance company products that guarantee a specific rate of return on the invested capital over the life of the contract.

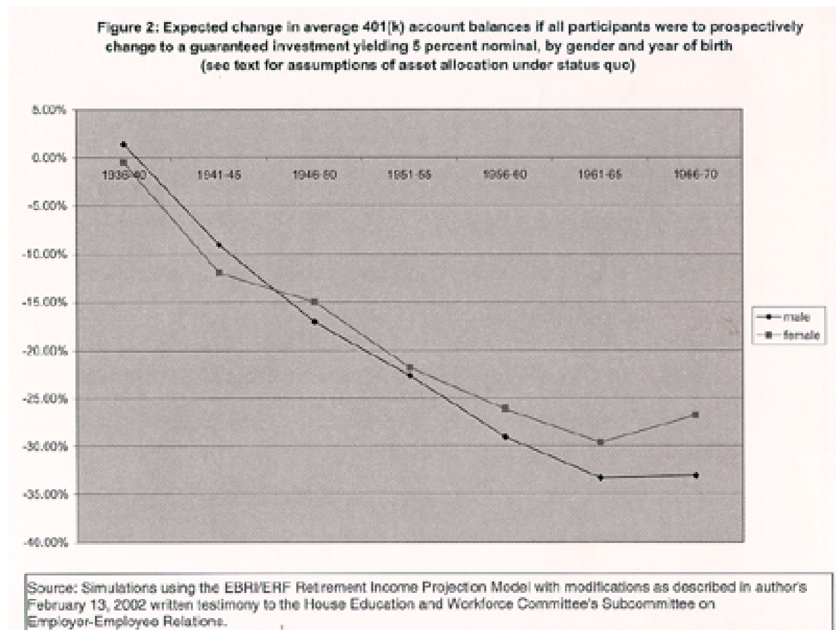
[28] See figure 2 of VanDerhei, "The Role of Company Stock in 401(k) Plans"

[29] Ibid. See Figure 3.

[30] Ibid. See Figure 4.

[31] Ibid. See Figure 5.

[32] Ibid. See Figure 6.
[33] Ibid. See the bottom two panels in Figure 6.
[34] Ibid. See the bottom two panels in Figure 7
[35] For recent EBRI/ICI research on the contribution activity of 401(k) plan participants, see Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants," *EBRI Issue Brief* n. 238, October 2001.
[36] Source of contribution (employer versus employee) can be matched to fund information for a subset of the data providers in our sample. Of those plans in the 2000 EBRI/ICI database for which the appropriate data are available, less than 0.5% require employer contributions to be invested in company stock. However, most of the plans with this feature are large, covering 6% of participants and 10% of plan assets in the subset.
[37] For this group, the participant-directed portion of the account balances represents 65% of the total account balances.
[38] See figure 9 of VanDerhei, "The Role of Company Stock in 401(k) Plans"
[39] See Scott Burns, "Examining Your Gift Horse," Dallas Morning News, April 17, 2001, for an excellent example of the tradeoff of risk between the S&P 500 Index and an individual stock.
[40] See VanDerhei, "The Role of Company Stock in 401(k) Plans" for details of the simulation
[41] Ibid. The distributional results for this population are shown in Figure 14.
[42] The computations assume a long-term average return of 11% for both a diversified portfolio and an individual stock but a standard deviation of 19.6% for the former compared to 65% for the latter. I have arbitrarily assumed all nonequity investments earn an annual rate of return of 6%.
[43] This portion of the model does not currently provide simulations for cohorts born after 1970.



Responses to Questions From Senator Graham

Question 1: Your written testimony suggests that employees may be better off with mandatory employer stock investments in their 401(k) plans because it forces them to allocate a greater portion of their account to equity investments than surveys suggest they do on their own. Is that correct?

Answer: In general this is correct subject to the following modifications:

1. This is not based on survey evidence; instead, it is analysis based on the actual administrative data.
2. Mandatory employer stock investments will not force all employees to have more equity in their 401(k) portfolio but we have found that it does increase the average equity concentrations.
3. The term "better off" is a subjective term. I merely stated that the expected average account balances would be larger. This obviously needs to be weighed against the increase volatility that was also modeled in my analysis.

Question 2: Your testimony goes on to quantify the gains associated with this "forced" equity investment. . . . Have you quantified the increased risk that these participants incur to gain these added returns?

Answer: Yes. Because the Committee's 10 page limit prevented me from including an additional table, I was forced to cross reference my previous testimony to the House Education and Workforce Committee in footnote 41. The text from that testimony follows:

> The distributional results for this population are shown in Figure 14. For example, at least 25 pct of the sample is expected to gain 5.1% or more if they were allowed to have company stock going forward, while at least 25% of the sample is expected to lose 10.8% or more if company stock continues to be permitted.

Figure 14

Distribution Of Gain From Retention Of Company Stock In 401(K) Plans As A Percentage Of Simulated 401(K) Balances Without Company Stock, Assuming Complete Independence

Percentile	Percentage gain
99%	75.8%
95%	32.6%
90%	18.7%
75%	5.1%
50%	-0.5%
25%	-10.8%
10%	-26.0%
5%	-35.7%
1%	-56.5%

Question 2b: How would these returns differ if the employer stock used in these calculations was substituted with a diversified equity portfolio?

Answer: The returns, per se, would not differ since I purposely chose my assumptions in such a manner that there would be no differential in the means between diversified equity and company stock (so as not be accused of biasing the results).

Thank you for the opportunity to respond to these questions. Please let me know if I can provide any additional information.

United States General Accounting Office

GAO

Testimony
Before the Senate Finance Committee

For Release on Delivery
Expected at 2:00 p.m.,
Wednesday, February 27, 2002

PRIVATE PENSIONS

Key Issues to Consider Following the Enron Collapse

Statement of David M. Walker
Comptroller General of the United States

GAO-02-480T

Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide you with preliminary observations on some of the challenges facing our nation's private pension system. Pension income is crucial to American retirees' standard of living. About half of Americans over 65 receive payments from pensions and savings plans, and such income represents about 18 percent of their total income. Over 70 million workers participate in pension and savings plans, and such plans in 1997 represented about $3.6 trillion in retirement savings.

The federal government encourages employers to sponsor and maintain pension and savings plans for their employees. The private pension system is voluntary and consists of defined benefit plans and defined contribution plans. Defined benefit plans promise to provide a level of retirement income that is generally based on salary and years of service. Defined contribution plans are based on the contributions to and investment returns on the individual accounts. Such plans include thrift savings plans, profit-sharing plans, and employee stock ownership plans (ESOPs).

The financial collapse of the Enron Corporation and its effect on the company's workers and retirees suggests certain vulnerabilities in these selected savings mechanisms. Enron's retirement plans, which included a defined benefit cash balance plan, a defined contribution 401(k) plan, and an ESOP, caused Congress to question specifically the use of employer stock as the company match, the continued existence of floor offsets, and the practice of investment freezes or lockdowns during changes in plan administrators. The financial losses suffered by participants in Enron's retirement plans have raised questions about the benefits and limitations of such private pension and savings plans and the challenges employees face in saving for retirement through their employer-provided plans.

You asked me here today to help provide context for considering how to address the vulnerabilities the Enron case may suggest. Accordingly, I will discuss three areas that, because of the experience with Enron, appear particularly salient to policymakers' decisions: (1) the importance of investment diversification and related investor education issues; (2) the crucial role of disclosure, and what information employees need and can expect about their company and their pension plans; and (3) the importance of fiduciary rules in safeguarding employee pension assets. In discussing these three issues, I will also address certain plan design issues such as floor-offsets, using company stock in pension plans, and plan operation issues, such as investment freezes or lockdowns. My

observations are based on prior GAO work, a preliminary review of Enron's and other public companies' plans, discussions with industry experts and senior regulatory officials, and my personal experience, including my former position as Assistant Secretary of Labor for Pension and Welfare Benefit Programs.

In summary, the collapse of the Enron Corporation and the accompanying loss of Enron employees' retirement savings appear to highlight vulnerabilities in the private pension system and help focus attention on strengthening several aspects of this system. Diversification of pension assets is crucially important, particularly in a world where the use of defined contribution plans—those plans in which employees bear the investment risk—is increasing. If both the employees' 401(k) contributions and the company match are largely in employer stock, as was the case at Enron, employees risk losing not only their jobs should the company go out of business, but also a significant portion of their retirement savings. The Enron situation suggests the importance of encouraging employees to diversify but any action would have to be balanced against the desires of employers and employees to maintain a portion of retirement savings in company stock. In addition, the Enron situation illustrates the need to provide employees with investment education and advice that will enable them to better manage their retirement savings.

Workers need clear and understandable information about their pension plans to make wise retirement saving decisions. While disclosure rules state that plan sponsors must provide plan participants with a summary of benefits and rights under their pension plan and notification when plan benefits are changed, such information is not always clear, particularly in describing complex plans, like floor-offset arrangements. We have also observed in earlier work that wide variation exists in the type and amounts of information workers receive about plan changes that can potentially reduce pension benefits, and enhanced disclosure requirements may be warranted. Furthermore, employees, like other investors, need reliable and understandable information about a company's financial condition and prospects.

Finally, fiduciary standards form the cornerstone of private pension protections. These standards require plan sponsors to act in a manner that is solely in the interest of plan participants and beneficiaries. In the end, investigations of Enron's actions related to its plans will determine whether plan fiduciaries acted in accordance with these responsibilities. In light of Enron, policymakers may wish to consider whether current fiduciary standards are sufficient or whether they require strengthening,

and act accordingly to address these fundamental principles of pension management.

The Enron collapse provides the Congress with clear examples of issues it may wish to consider when deciding whether and how to strengthen the security of plan benefits. These issues include employees' need for enhanced education and appropriate investment advice, plan designs such as floor-offset arrangements and the use of employer stock in retirement savings plans, and plan operations, such as plan investment freezes and lockdowns. Addressing these issues will require balancing the need for greater participant protections with the potential increase in employer burden that could undermine their willingness to sponsor or contribute to such plans.

Background

The Internal Revenue Code (IRC) defines pension plans as either defined benefit or defined contribution and includes separate requirements for each type of plan. The employer, as plan sponsor, is responsible for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk. If a defined benefit plan terminates with insufficient assets to pay promised benefits, the Pension Benefit Guaranty Corporation (PBGC) provides plan termination insurance to pay participants' pension benefits up to certain limits.

Under defined contribution plans, employees have individual accounts to which employers, employees, or both make periodic contributions. Plans that allow employees to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of IRC are generally referred to as 401(k) plans. In many 401(k) plans employees can control the investments in their account while in other plans the employer controls the investments. ESOPs may also be combined with other pension plans, such as a profit-sharing plan or a 401(k) plan.[1] Investment income earned on a 401(k) plan accumulates tax-free until an individual withdraws the funds. In a defined contribution plan, the employee bears the investment risk, and plan participants have no termination insurance.

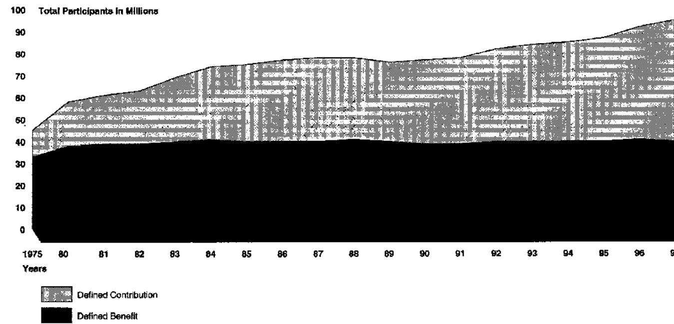
The Internal Revenue Service (IRS) and the Pension and Welfare Benefits Administration (PWBA) of the Department of Labor (DOL) are primarily responsible for enforcing laws related to private pension plans. Under the

[1] When an ESOP is combined with a 401(k) plan, it is called a KSOP.

Employee Retirement Income Security Act of 1974 (ERISA), as amended, IRS enforces coverage and participation, vesting, and funding standards that concern how plan participants become eligible to participate in benefit plans, earn rights to benefits, and reasonable assurance that plans have sufficient assets to pay promised benefits. IRS also enforces provisions of the IRC that apply to pension plans, including provisions under section 401(k) of the IRC. PWBA enforces ERISA's reporting and disclosure provisions and fiduciary standards, which concern how plans should operate in the best interest of participants.

Since the 1980's, there has been a significant shift from defined benefit plans to defined contribution pension plans. Many employers sponsor both types of plans, with the defined contribution plan supplementing the defined benefit plan. However, most of the new pension plans adopted by employers are defined contribution plans. According to the Department of Labor, employers sponsored over 660,000 defined contribution plans as of 1997 compared with about 59,000 defined benefit plans. As shown in figure 1, defined contribution plans covered about 55 million participants, while defined benefit plans covered over 40 million participants in 1997.

Figure 1: Participants in Private Pension Plans, 1997



The number of employer-sponsored 401(k) plans has also increased substantially in recent years, increasing from over 17,000 in 1984 to over 265,000 plans in 1997. In 1997, 401(k) plans accounted for 40 percent of all employer-sponsored defined contribution plans and approximately 37 percent of all private pension plans. Approximately 33.8 million employees actively participated in a 401(k) plan, and these plans held about $1.3 trillion in assets as of 1997.[2]

The continued growth in the number of defined contribution plans and plan assets is encouraging, but concerns remain that many workers who traditionally lack pensions may not be benefiting from these plans, and the overall percentage of workers covered by pensions has remained relatively stable for many years. Furthermore, the trend toward defined contribution plans and the increased availability of lump-sum payments from pension plans when workers change jobs raises issues of whether workers will

[2] "Private Pension Plan Bulletin: Abstract of 1997, Form 5500 Annual Reports." US Department of Labor, Pension and Welfare Benefits Administration. Winter 2001.

preserve their pension benefits until retirement or outlive their retirement assets.

Similar to other large companies, Enron sponsored both a defined benefit plan and a defined contribution plan, covering over 20,000 employees. Enron's tax-qualified pension plans consisted of a 401(k)-defined contribution plan, an employee stock ownership plan, and a defined benefit cash balance plan. Under Enron's 401(k) plan, participants were allowed to contribute from 1 to 15 percent of their eligible base pay in any combination of pre-tax salary deferrals or after-tax contributions subject to certain limitations.[3] Enron generally matched 50 percent of all participants' pre-tax contributions up to a maximum of 6 percent of an employee's base pay, with the matching contributions invested solely in the Enron Corporation Stock Fund. Participants were allowed to reallocate their company matching contributions among other investment options when they reached the age of 50.[4]

Enron's employee stock ownership plan,[5] like other ESOPs, was designed to encourage employee ownership in their company. The plan provided employee retirement benefits for workers' service with the company

[3] Participants were immediately fully vested in their voluntary contributions and employees hired after July 1999 are fully vested in their company contributions after 1 year of service.

[4] For defined benefit plans, ERISA limits the amount of employer stock and real property that can be held to 10 percent of plan assets. However, defined contribution plans, including 401(k) plans, ESOPs, and other defined contribution plans with individual accounts, are generally exempt from this requirement. While the vast majority of 401(k) plans are thus not subject to any restriction on the amount of employer stock that it may hold, there are limited circumstances under which the 10 percent limitation could apply to a 401(k) plan.

[5] The ESOP provided for three subaccounts, (1) a savings subaccount where the plan allocated shares of Enron stock equal to 10 percent of each participant's base pay; (2) a retirement subaccount where the plan allocated shares of Enron stock based on each participant's age, years of service, and base pay; and (3) a special subaccount for participants active on December 31, 1994, where the participants received an allocation to this account and the defined benefit portion of their retirement plan. This allocation in total equaled 5 percent of their base pay and was in lieu of an accrual to their 1995 defined benefit plan. According to Enron plan documents, the vested portion of a participant's retirement subaccount was used to offset the benefit they earned from Enron's cash balance plan from January 1, 1987 through December 31, 1994. The offset was calculated using the value of the shares of Enron stock based on the earlier of when the shares were distributed or when the shares were available to be withdrawn from the ESOP. Once a plan participant has access to the shares of his or her retirement subaccount, the shares' value is used to offset the benefit they have earned from the Enron defined benefit plan for their service between January 1, 1987, and December 31, 1994.

between January 1, 1987, and December 31, 1994. No new participants were allowed into the ESOP after January 1, 1995.

Finally, Enron sponsored a cash balance plan, which accrued retirement benefits to employees during their employment at Enron. An employee was eligible to be a member of the cash balance plan immediately upon being employed. According to DOL officials, the cash balance plan did not have any investments in Enron stock as of the end of 2000. If the plan is unable to pay promised benefits and is taken over by PBGC, vested participants and retirees will receive their promised benefits up to the limit guaranteed under ERISA.

Greater Diversification and Investment Sophistication May Be Needed

The Enron collapse points to the importance of prudent investment principles such as diversification, including diversification of employer matching contributions. Diversification helps individuals to mitigate the risk of holding stocks by spreading their holdings over many investments and reducing excessive exposure to any one source of risk. Many workers are covered by participant-directed 401(k) plans that allow participants to allocate the investment of their account balances among a menu of investment options, including employer stock. Additionally, many plan sponsors match participants' elective contributions with shares of employer stock.

When the employer's stock constitutes the majority of employees' account balances and is the only type of matching contribution the employer provides, employees are exposed to the possibility of losing more than their job if the company goes out of business or into serious financial decline. They are also exposed to the possibility of losing a major portion of their retirement savings. For example, DOL reports that 63 percent of Enron's 401(k) assets were invested in company stock as of the end of 2000. These concentrations are the result both of employee investment choice and employer matching with company stock. The types of losses experienced by Enron employees could have been limited if employees had diversified their account balances and if they had been able to diversify their company matching contributions more quickly.

Companies prefer to match employees' contributions with company stock for a number of reasons. First, when a company makes its matching contribution in the form of company stock, issuing the stock has little impact on the company's financial statement in the short term. Second, stock contributions are fully deductible as a business expense for tax purposes at the share price in effect when the company contributes them. Third, matching contributions in company stock puts more company

shares in the hands of employees who some officials feel are less likely to sell their shares if the company's profits are less than expected or in the event of a takeover. Finally, companies point out that matching with company stock promotes a sense of employee ownership, linking the interests of employees with the company and other shareholders.

Some pension experts have said that easing employer restrictions on when employees are allowed to sell their company matching contributions would increase their ability to diversify. In 1997, a majority of the Pension and Welfare Benefits Administration Advisory Council working group on employer assets in ERISA plans recommended that participants in 401(k) plans be able to sell employer stock when they become vested in the plan.[6] Additionally, legislation has recently been introduced that would limit the amount of employer stock that can be held in participants' 401(k) accounts and provide participants greater freedom to diversify their employer matching contributions. Proponents of allowing employees to diversify employer stock matching contributions more quickly say that this would benefit both employers and employees by maintaining the tax and financial benefits for the company while providing employees with more investment freedom and increased retirement benefit security. However, others have expressed concern that further restrictions on employer plan designs may reduce incentives for employers to sponsor plans or provide matching contributions.

Even with opportunities to diversify, studies indicate that employees will need education to improve their ability to manage their retirement savings. Numerous studies have looked at how well individuals who are currently investing understand investments and the markets.[7] On the basis of those studies, it is clear that among those who save through their company's retirement programs or on their own, large percentages of the investing population are unsophisticated and do not fully understand the risks associated with their investment choices. For example, one study found that 47 percent of 401(k) plan participants believe that stocks are components of a money market fund, and 55 percent of those surveyed

[6] Pension and Welfare Benefits Administration Advisory Council on Employee Welfare and Pension Benefits Plans, Report of the Working Group on Employer Assets in ERISA Employer-Sponsored Plans, November 13, 1997.

[7] U.S. General Accounting Office, *Social Security: Capital Markets and Educational Issues Associated With Individual Accounts*, GAO/GGD-99-115 (Washington, D.C., June 1999).

thought that they could not lose money in government bond funds. Another study on the financial literacy of mutual fund investors found that less than half of all investors correctly understood the purpose of diversification. These studies and others indicate the need for enhanced investment education about such topics as investing, the relationship between risk and return, and the potential benefits of diversification.

In addition to investor education, employees may need more individualized investment advice. Such investment advice becomes even more important as participation in 401(k) plans continues to increase. ERISA does not require plan sponsors to make investment advice available to plan participants. Under ERISA, providing investment advice results in fiduciary responsibility for those providing the advice, while providing investment education does not. ERISA does, however, establish conditions employers must meet[8] in order to be shielded from fiduciary liability related to investment choices made by employees in their participant-directed accounts. In 1996, DOL issued guidance to employers and investment advisers on how to provide educational investment information and analysis to participants without triggering fiduciary liability. DOL recently issued guidance about investment advice making it easier for plans to use independent investment advisors to provide advice to employees in retirement plans.

Industry representatives that we spoke with said more companies are providing informational sessions with investment advisors to help employees better understand their investments and the risk of not diversifying. They also said that changes are needed under ERISA to better shield employers from fiduciary liability for investment advisors' recommendations to individual participants. ERISA currently prohibits fiduciary investment advisors from engaging in transactions with clients' plans where they have a conflict of interest, for example, when the advisors are providing other services such as plan administration. As a result, investment advisors cannot provide specific investment advice to 401(k) plan participants about their firm's investment products without approval from DOL. Various legislative proposals have been introduced that would address employers' concern about fiduciary liability when they make investment advice available to plan participants and make it easier for fiduciary investment advisors to provide investment advice to

[8] These include a minimum number of investment options and related material that must be provided to participants.

participants when they also provide other services to the participants' plan. However, concerns remain that such proposals may not adequately protect plan participants from conflicted advice.

Enhanced Disclosure Could Help Employees Understand Investment Risks They Face

Enron's failure highlights the importance of plan participants receiving clear information about their pension plan and any changes to it that could affect plan benefits. Current ERISA disclosure requirements provide only minimum guidelines that firms must follow on the type of information they provide plan participants. Improving the amount of disclosure provided to plan participants and also ensuring that such disclosure is in plain English could help participants better manage the risks they face.

Enron's pension plans illustrate the complex nature of some plan designs that may be difficult for participants to understand. For example, Enron's pension plans included a floor-offset arrangement. Such arrangements consist of separate, but associated defined benefit and defined contribution plans. The benefits accrued under one plan offset the benefit payable from the other. In 1987, Congress limited the use of such plans. However, plans in existence when the provision was enacted, including Enron's plan, were grandfathered. In addition, Enron's conversion of its defined benefit plan from one type of benefit formula to another illustrates the types of changes and their consequent affect on benefits that plan participants need to understand. Enron's defined benefit plan was converted from a final average pay formula—where the pension benefit is a percentage of the participant's final years of pay multiplied by his or her length of service—to a cash balance formula, which expresses the defined benefit as a hypothetical account balance. As we have previously reported, conversions to cash balance plans can be advantageous to certain groups of workers—for example, those who switch jobs frequently—but can lower the pension benefits of others.[9]

The extent to which Enron employees were informed or understood the effect of the floor-offset or the conversion of their defined benefit plan to a cash balance formula is unclear. As stated in a prior GAO report on cash balance plans[10], we found wide variation in the type and amounts of information workers receive about plan changes and that can potentially

[9] U.S. General Accounting Office, *Private Pension Plans: Implications of Conversions to Cash Balance Plans*, GAO/HEHS-00-185, (Washington, D.C., September 2000).

[10] See footnote 9.

reduce pensions benefits. Based in part on our recommendations, the Congress, under the Economics Growth and Tax Relief Reconciliation Act of 2001, required that employers provide participants more timely and clear information concerning changes to plans that could reduce their future benefits. The Treasury Department is responsible for issuing the applicable regulations implementing this requirement. [11]

Other types of information may also be beneficial to plan participants. Currently, ERISA requires that plan administrators provide each plan participant with a summary of certain financial data reported to DOL. As we previously reported,[12] the Secretary of Labor could require that plan administrators provide plan participants with information about the employers' financial condition and other information. Such information could enable employees to be more fully informed about their holdings and any potential risks associated with them.

ERISA Requires Fiduciaries to be Prudent and Reasonable

Under ERISA, fiduciaries are held to high but broad standards. Persons who perform certain tasks, generally involving the use of a plan's assets, become fiduciaries because of those duties. Others, such as the plan sponsor, the plan administrator, or a trustee are fiduciaries because of their position. Fiduciaries are required to act solely in the interest of plan participants and beneficiaries. They are to adhere to a standard referred to as the prudent expert rule, which requires them to act as a prudent person experienced in such matters would in similar circumstances. Fiduciaries are required to follow their plan's documents and act in accordance with the terms of the plan as it is set out. If fiduciaries do not perform their duties in accordance with ERISA standards, they may be held personally liable for any breach of their duty.

Yet, even with the high standards and broad guidance provided by ERISA, in some cases the actions of fiduciaries can seem to conflict with the best interests of plan participants. During the period when revelations about Enron's finances were contributing to the steady devaluation of Enron's stock price, Enron's plan fiduciaries imposed a lockdown on the 401(k) plan, preventing employees from making withdrawals or investment

[11] Public Law 107-16.

[12] U.S. General Accounting Office, *401(k) Pension Plans: Extent of Plans' Investments in Employer Securities and Real Property*, GAO/HEHS-98-28 (Washington, D.C., November 1997).

transfers.[13] Enron imposed the lockdown to change recordkeepers, an acceptable practice. Some observers, however, have questioned whether Enron employees were sufficiently notified about the lockdown. Observers have also questioned the equity of treatment between Enron senior executives and Enron workers during the lockdown. Enron's employees were unable to make changes to their 401(k) accounts during the plan's lockdown period. However, Enron executives did not face similar restrictions on company stock not held in the plan. Fairness would suggest that company executives should face similar restrictions in their ability to sell company stock during lockdown periods when workers are unable to make 401(k) investment changes. This is especially true for those executives who serve as pension plan fiduciaries, including plan trustees.

Conclusions

The Enron collapse, although not by itself evidence that private pension law should be changed, serves to illustrate what can happen to employees' retirement savings under certain conditions. Specifically, it illustrates the importance of diversification for retirement savings as well as employees' need for enhanced education, appropriate investment advice, and greater disclosure. All of these may help them better navigate the risks they face in saving for retirement.

In addition to the broad issues of diversification and education, Enron's collapse raises questions about the relationship between various plan designs and participant benefit security. In particular, Congress may wish to consider whether further restrictions on floor-offset arrangements are warranted, whether to provide additional employee flexibility in connection with matches in the form of employer stocks, and whether to limit the amount of employer stock that can be held in certain retirement saving plans. Resolving these issues will require considering the tradeoffs between providing greater participant protections and employers' need for flexibility in plan design. Finally, Congress will have to weigh whether to rely on the broad fiduciary standards established in ERISA that currently govern fiduciary actions or to impose specific requirements that would govern certain plan administrative operations such as plan investment freezes or lockdowns.

[13] The Department of Labor is investigating Enron to determine whether there were any ERISA violations in the operation of the company's employee benefit plans. DOL also recently reached an agreement with Enron to appoint an independent fiduciary to assume control of the company's retirement plans.

Mr. Chairman this concludes my statement. I would be happy to answer any questions you or other members of the Committees may have.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, or George A. Scott, Assistant Director, Education, Workforce, and Income Security (202) 512-7215. Individuals making key contributions to this testimony include Joseph Applebaum, Jeremy Citro, Tamara Cross, Patrick DiBattista, Raun Lazier, and Roger Thomas.

RESPONSES TO QUESTIONS FROM SENATOR GRAHAM

Question 1: You cautioned the Committee to be cognizant of administrative difficulties involved with imposing a specific limit on the amount of employer stock an employee could hold in a 401(k) account. However, ERNA already imposes a 10 percent limit on the amount of qualifying employer securities that can be held by a plan. How is this limit currently administered by plans subject to it? Can the rules used in administering this limit apply to 401(k) plans?

Answer: Applying a broad limit on employer stock in 401(k) plans similar to the limit that is currently applied to defined benefits plans under ERISA would be more difficult to administer under a 401(k) plan than under a defined benefit plan. Currently, the 10 percent rule requires that a defined benefit plan may not acquire employer stock or real property if immediately after the acquisition, the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan. The defined benefit plan sponsor can readily determine if the value of employer stock will exceed 10 percent of the total plan assets. Moreover, the responsible plan fiduciaries have sole decisionmaking authority over what will be done with all plan investments. Furthermore, contributions to defined benefit plans are made with much less frequency than contributions to defined contribution plans.

401(k) plans that are designed to operate as "eligible individual account plans" under ERISA are exempt from the 10 percent rule. This allows employees to invest more than 10 percent of their contributions in employer securities. In addition, it allows the employer to make matching contributions in the form of employer securities. Some employers may make matches using an accompanying ESOP.

Imposing a more broadly applied limit on employer stock in 401(k) plans would be challenging administratively. Issues arise such as having to enforce the rule on a participant-by-participant basis and making sure the asset allocations of each participant are made. For example, the plan sponsor of a large 401(k) plan would have to apply the limit to thousands of participants' accounts in 401(k) plans. Furthermore, as the market value of the employer stock changes, the market value of each participant's holdings in employer stock would change. Thus, deciding when the limit would apply would also present a challenge; policymakers would have to specify whether the fair market value would be determined on an annual, a quarterly, or a daily basis.

Applying a limit on employer securities in 401(k) plans will also not address the more fundamental problem of the need for more informed investment decision-making by plan participants. As stated in my testimony, plan participants need more investment education and independent investment advice. Investment education could include materials informing participants about investment concepts, such as risk and return, diversification, dollar cost averaging, and compounded returns. More emphasis on independent and customized investment advice would also help. Investment advice that is honest and uncompromised by conflicts of interest could help employees better understand their investment time horizons, risk tolerance, and future retirement income needs, as well as emphasize the need for proper diversification. Providing more customized education and investment advice could broaden plan participants' perspective and enable them to make better judgments about

their retirement income security, thus helping employees understand the risks of concentrating their investments, especially in their employer's securities.

Question 2: In your testimony, you suggested that the Committee may want to segregate stand-alone ESOP plans from those integrated with 401(k) plans for purposes of creating rules to minimize the concentration of retirement plan assets in employer stock. Can you elaborate on that point?

Answer: 401(k) plans are normally structured as defined contribution plans which enable employees to make pretax contributions by salary reductions to their accounts. ESOPs are also defined contribution plans, but in ESOPs, assets are required by law to invest primarily in employer securities that the employer purchases and allocates to plan participants who then become shareholders of the company. ESOPs are viewed more as vehicles to foster employee ownership in the company than as retirement programs. The majority of ESOPs are also with companies that are not publicly traded. KSOPs are defined contribution plans that combine elements of 401(k)s with ESOPs by matching the employee 401(k) contribution with shares of company stock under an ESOP arrangement.

It is important to treat stand-alone ESOPs (that is, an ESOP that does not hold 401(k) contributions, matching contributions, or other contributions used to satisfy the Internal Revenue Code nondiscrimination tests) differently than 401(k) plans or KSOPs when seeking ways to minimize the concentration of retirement plan assets in employer stock. This is because ESOPs are required by law to invest primarily in employer stock and because of the purpose of standalone ESOPs. If the law were changed to force stand-alone ESOPs to limit the concentration of employer stock, especially in privately traded company ESOPs, employer incentives for offering such plans could be undermined.

Rather than placing limits on the amount of employer stock that can be held in ESOPs, 401(k) plans, or KSOPs, one option could allow participants to more quickly diversify their account holdings in such plans. For example, with an ESOP you could allow participants to diversify 25 percent of the value of their ESOP account at age 45, 50 percent of the value at age 50, and 75 percent of the value of their ESOP account at age 55. Similarly, as stated in my testimony, easing employer restrictions on when employees in 401(k) plans are allowed to sell their company matching contribution is another one way of providing quicker diversification. Several of the current legislative proposals include provisions requiring quicker diversification. As long as employers are able to maintain the tax benefits of such plans, especially the tax deductions for related dividends, they may be open to allowing quicker diversification of employer stock holdings.

Question 3: If the Committee decided to impose restrictions that limit the amount of employer stock that can be held in 401(k) plans while at the same time retaining stand-alone ESOPs as alternative retirement plans, what, if any, rules would you suggest to prevent plan sponsors from simply switching to ESOPs?

Answer: Permitting earlier diversification of employer matching contributions in company stock rather than imposing a broad limit on the amount of employer stock that can be held in 401(k) plans could help prevent such switching. While this may affect the incentive some employers have for providing matching contributions, it may be less likely to cause employers to switch from 401(k) plans to ESOPs. In addition, requiring stand-alone ESOPs to allow plan participants to diversify their account holdings more rapidly (as noted in the answer to question number 2) could also serve to reduce incentives to switch.

Question 4: In your testimony, you state that one of the reasons that plan sponsors use employer stock to meet their matching requirements is that doing so has little impact on the company's financial statement. Can you elaborate on this point?

Answer: Whether a company makes a contribution to its 401(k) plan in cash or in its own unleveraged stock makes little or no difference to company financial statements; the effect of the contribution on reported earnings is the same. Both forms of contribution result in an expense to the company. The expense related to the stock contribution is measured by the value of the stock at the date of contribution. In the longer term, making the contribution in cash reduces the amount of cash the company has available to employ in operations. The use of company stock to fund this expense results in a greater number of company shares outstanding, which has the effect—often small—of diluting reported earnings per share.

When a leveraged ESOP is used to make employer matching contributions the accounting treatment is much more complex, but the employer's compensation expense is still based on the fair value of the stock. In certain circumstances, the use of dividends for debt reduction can result in reducing the employer's compensation expense. Leveraged ESOPs have been accorded a number of additional tax benefits (such as deductions of certain dividends) that have served to encourage greater use of such plans to satisfy employer matching requirements.

Question 5: Your testimony suggests that the financial statements of a company that uses employer stock to fund its 401(k) matching obligations reflect a lower compensation expense than the financial statements of a company that uses cash to make the same amount of matching contributions. Has the General Accounting Office investigated the effect this preferential accounting treatment has had on the earnings of those public companies who use employer stock to meet their 401(k) matching requirements?

Answer: Some companies may prefer to use employer stock to fund its 401(k) matching contributions because it has the advantageous effect of "freeing up" cash for company operations. However, our statement did not intend to infer any preferential accounting treatment related to this issue. Please see the response to question number 4 above for certain accounting related issues.

COMMUNICATIONS

STATEMENT OF THE AMERICAN PREPAID LEGAL SERVICES INSTITUTE

[SUBMITTED BY WAYNE MOORE, PRESIDENT]

Mr. Chairman and Members of the Committee:

I am Wayne Moore, President of the American Prepaid Legal Services Institute. The American Prepaid Legal Services Institute (API) is a professional trade organization representing the legal services plan industry. Headquartered in Chicago, API is affiliated with the American Bar Association. Our membership includes the administrators, sponsors and provider attorneys for the largest and most developed legal services plans in the nation. The API is looked upon nationally as the primary voice for the legal services plan industry.

The hearing today deals with protection of retirement benefits, particularly for those employees participating in defined contribution pension plans. Current Department of Labor statistics put the number of Americans participating in 401(k) plans at 42 million, with over $2 trillion in assets invested. Although the pension issues in the Enron situation have brought employer restrictions on 401(k) plans into the national spotlight, there are other important pension security issues that should and can be addressed by a simple system.

Our society, and retirement plans have become increasingly more portable to accommodate that mobility. When employees change jobs or retire, funds must be rolled into another qualified plan. It is during this rollover period that the employee and the funds are at the highest risk. Unfortunately, there are unscrupulous brokers who take advantage of employees' vulnerabilities and advise investment of these retirement savings in risky, inappropriate or fraudulent schemes.

Achieving a balance between promoting and protecting retirement savings will be difficult. However, a system already exists to help employees deal with some of these retirement security issues without costly over-regulation of pension funds. This mechanism is the qualified group legal services plan under IRC Section 120.

When Congress first enacted Internal Revenue Code Section 120 in 1976, employers were provided with an incentive to provide their workforce with group legal services benefits at modest cost. These benefit programs enable employees to contact an attorney and get advice and, if necessary, representation. Most plans cover the everyday legal life events that we all expect to encounter, from house closings and adoptions to traffic tickets and drafting wills. However, the provision expired in 1992, eliminating this valuable benefit's favorable tax status.

As part of the 2001 tax bill, President Bush signed an amendment to Internal Revenue Code Section 132(a) adding qualified retirement planning services to the list of statutory exclusions from gross income. These services are defined as "any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan." A logical extension of the sound public policy behind the amendment to Section 132, is to encourage access to the legal services that will surely arise out of any comprehensive retirement planning, including wills and trust documents. It is a consistent policy decision to encourage employers to provide legal services, as well as retirement planning services.

In the area of pension benefits, access to a group legal plan can increase the security of employees' retirement savings. President Bush, in discussing his retirement security plan at the 2002 National Summit on Retirement Savings stated, "Americans can help secure their own future by saving. Government must support policies that promote and protect saving. But there's still more to do. Even when people are saving enough, they need to feel more secure about the laws protecting their savings."

Qualified employer-paid plans have proven to be highly efficient. These arrangements make substantial legal service benefits available to participants at a fraction

of what medical and other benefit plans cost. For an average employer contribution of less than $100 annually, employees are eligible to utilize a wide range of legal services often worth hundreds and even thousands of dollars, which otherwise would be well beyond their means.

In addition to the efficiency with which these plans can deliver services, their ability to make preventive legal services available results in additional savings in our economy. Group legal plans give investors access to legal services, before they are induced to make unwise investments. Having a lawyer available to review the investment documents could mean the difference between a comfortable retirement and lost life savings. Group legal plan attorneys add a layer of security to the system.

Here are a few brief examples of how legal plan attorneys were able to provide retirement security. Keep in mind that regardless of the system, we all have the same goal: promotion of voluntary employer-based retirement options and the protection of those retirement savings.

In Kokomo and Marion, Indiana group legal plan attorneys are working with 50 plan members who were among hundreds of individuals taken in by a sophisticated investment scam. Between $22 and $30 million has disappeared. This represents the life savings of working couples who put away money in IRAs and 401(k) accounts for 20 years. When it came time to roll it into an account they could draw upon during the retirement for which they had worked so hard, they put their trust in the wrong person.

Joe Smith (not his real name) had lived in the Marion, Indiana area for twenty years. He operated two investment businesses. Records show that between 1997 and January 1999, Smith deposited over $3.3 million into one account alone. He told investors that he was trading in commodity futures although he is not registered with the Commodity Futures Trading Commission (CFTC). He claimed it was a "safe investment" and he could triple their money. Smith created false trade logs purporting to show millions of dollars in trades. However, CFTC records show no actual trades made by any accounts controlled by Mr. Smith. Soon after his first meeting with the CFTC to discuss the discrepancies, Mr. Smith disappeared. Investigators said that after following a paper trail they were able to put a human face on the tragedy at the courthouse where they talked with 40–50 of Smith's customers. There they saw the emotional and financial toll Smith and his scam had taken on these people. The FBI is still looking for Mr. Smith in connection with securities and internet fraud.

If these unscrupulous brokers can get $22 million in Kokomo, how much retirement money is being stolen across the country? The group legal plan attorneys, working with local and federal prosecutors, have already recovered $3 million. This particular group legal plan has 75 offices nationwide and covers almost one million Americans, all of whom have retirement savings that could be at risk. Group legal plans can give investors somewhere to turn for a second opinion on an investment vehicle that sounds too good to be true and somewhere to go for help in cases of fraud or misrepresentation.

Another office is helping a widow in Ohio recover money she received from her husband's wrongful death case. When it came time to invest the settlement funds, she wanted to set up an estate plan that would provide money to educate family members and make charitable contributions to her church and community. She turned to a trusted neighbor who was a broker for assistance in managing this large sum of money. Unfortunately, he suggested a loan to a business, and when the money was not returned in accordance with the promissory note or the broker's repeated promises, the widow called the legal plan office. The plan attorney was able to get into court within two days and freeze whatever assets were available. Access to a legal plan meant the difference between a total loss of this widow's retirement fund and the hope for a recovery of her money.

Legal plan members from Florida to Washington state were among the thousands of investors taken in by unscrupulous individuals and companies promising high returns from fraudulent investments in pay telephone schemes. Securities regulators in 25 states are working to identify the nearly 4500 people, most of them elderly, who lost an estimated $76 million investing in "coin-operated, customer-owned telephones." Court documents reveal that in the typical pay telephone scheme, a company sells phones to investors for between $5000 and $7000. As part of the deal, the company agrees to lease back and service the phones for a fee. The brokers used promises of 15 percent annual returns to convince the mostly elderly investors to withdraw money from their retirement accounts.

A group legal plan office in Canton, Michigan brought arbitration proceedings against one of the brokers who sold these high-risk investments. These plan members lost 50% of their retirement savings. They needed the savings to support one

of the spouses as her multiple sclerosis progressed and medical costs mounted. The broker promised to double their retirement savings in five years in an investment that was as safe as a certificate of deposit. The investment was "Secured," there was "No Market Risk/Income Fluctuation" and it was appropriate for "Use in Qualified Plans IRA, SEP and Keogh Qualified Plans." Her legal plan's fast action is another good example of how legal plans provide retirement security. They give workers of moderate means the access to counsel to combat fraudulent investment schemes by obtaining injunctions and judgments.

Other plan attorneys have told me that they are able to tell when a mailing for a new investment scheme goes out, by the increase in calls to their offices. Legal plan attorneys are able to save the retirement savings of plan members by reviewing the materials and advising members on what to look for in investments, given their individual circumstances. In some instances, plan attorneys have gone to their state attorneys general with materials and stopped investment scams before they rob thousands of taxpayers of their retirement savings.

Senator Robert Torricelli's bill, S. 654, would make permanent the beneficial tax status of employer-paid legal services benefits. This bill's passage would stimulate employers to offer group legal benefits and allow millions of working Americans access to legal advice when they need it to protect their retirement savings.

As President Bush said in his State of the Union Address: "A good job should lead to security in retirement. I ask Congress to enact new safeguards for 401(k) and pension plans. Employees who have worked hard and saved all their lives should not have to risk losing everything. . . ."

We recommend the passage of S. 654 as part of any retirement security package to protect millions of working Americans' retirement funds.