RETIREMENT SECURITY AND DEFINED CONTRIBUTION PLANS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 26, 2002

Serial No. 107–66

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

80–332 WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

CONTENTS

RETIREMENT SECURITY AND DEFINED CONTRIBUTION PLANS

TUESDAY, FEBRUARY 26, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 2:11 p.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 11, 2002
No. FC–15

CONTACT: (202) 225–1721

Thomas Announces a Hearing on Retirement Security and Defined Contribution Plans

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on retirement security and defined contribution plans. **The hearing will take place on Tuesday, February 26, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

Oral testimony will be heard from invited witnesses only. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

Private pension plans are an important component of retirement savings. In 1997 (the most recent year for which the U.S. Department of Labor data is available), 71 million workers actively participated in more than 720,000 pension plans. Assets held by private pension plans totaled $3.6 trillion in 1997. In general, private pension plans fall under two broad categories: defined benefit (DB) plans and defined contribution (DC) plans.

The DB plans provide participants with a guaranteed retirement benefit that is typically tied to the employee's earnings and/or length of service. Generally, employers are responsible for making contributions to the plan that are actuarially sufficient to fund promised benefits. The employer (or a chosen fiduciary) is responsible for directing plan investments and bears the risk of such investments. To ensure a certain level of solvency within DB plans, the Internal Revenue Code (IRC) sets forth certain minimum funding requirements that must be met on an ongoing basis. Most private-sector DB plans must pay premiums to the Pension Benefit Guaranty Corporation (PBGC) to insure the risk of plan termination without sufficient assets to pay benefits under the plan. The PBGC is required to pay a minimum guaranteed benefit to each plan participant in the case of such termination.

Under a DC plan, individual accounts are established for each participating employee. Accounts are funded with employer contributions, employee contributions, or both. A DC plan may be designed to allow participants to direct the investment of their account balances. Alternatively, the plan design may require that employer contributions be invested in employer assets or securities. Yet another design will require the plan sponsor (or an appointed investment manager) to direct the investment of all the plan assets. Retirement benefits under a DC plan are based on the individual's total account balance at retirement. In general, the minimum funding rules set forth in the IRC are not applicable to DC plans because DC plans are, by definition, fully funded through employer and/or employee contributions. Similarly, DC plans are not insured by the PBGC because there is no risk of termination with insufficient assets.

The past 20 years has seen a significant growth in DC plans. In 1977, 15 million individuals participated in 281,000 DC plans with $91 billion of total assets. By 1997, 55 million individuals participated in 661,000 plans with $1.8 trillion in assets. In 1997, about 54 percent of covered employees were covered only by a DC plan, 14 percent were covered only by a DB plan, and 32 percent were covered by both a DC and a DB plan.

The shift from DB plans to DC plans has provided many advantages for both employees and employers. However, the trend has also shifted some measure of the responsibility for financing retirement benefits from the employer to the employee. As a result, it is necessary that we examine the rules and regulations that currently govern DC plans as well as the existing protections for workers who participate in these plans.

In announcing the hearing, Chairman Thomas stated: "401(k) plans and other defined contribution pension plans have provided workers with important advantages, including the opportunity for increased retirement income and more portability—a feature that is particularly important for today's mobile workforce. However, defined contribution plans also shift more risk and responsibility to the employee. As defined contribution plans become more and more popular, we need to evaluate the laws that govern them to ensure we are maximizing retirement security while minimizing undue regulatory burdens that may discourage employers from offering these plans."

FOCUS OF THE HEARING:

The hearing will examine the rules and regulations that currently govern private DC pension plans. Specific issues to be discussed include rules regarding diversification of plan assets, restrictions placed on plan assets under the terms of the plan, standards for investment education and advice, and notice and reporting requirements. The hearing will also examine existing protections for plan participants, including fiduciary rules and applicable penalties for fraud and/or breach of the fiduciary rules. Witnesses will also discuss regulatory burdens associated with sponsoring certain retirement plans as well as the other challenges faced by employers who offer (or seek to offer) pension plans.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *"hearingclerks.waysandmeans@mail.house.gov"*, along with a fax copy to 202/225–2610 by the close of business, Tuesday, March 12, 2002. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing should deliver their 300 copies to the full Committee in room 1102 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse unopened and unsearchable deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *"hearingclerks.waysandmeans@mail.house.gov"*, along with a fax copy to 202/225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov/*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman THOMAS. If our guests could find seats, please? Thank you and good afternoon.

Today's examination of defined contribution pension plans is the first in a series of hearings that will allow the Committee on Ways and Means to look at significant aspects of retirement security for America's workers.

Private pension plans are an important component of retirement savings for millions of Americans. Historically, most American workers were covered by defined benefit (DB) plans that provided a guaranteed benefit at retirement after a number of years' commitment almost always at one company or corporation.

However, over the last two decades, we have seen an expansion in defined contribution pension plans. In a defined contribution plan, individual accounts are established for each worker and funded with either employer contributions, employee contributions, or a mix of both. These contributions are usually invested at the worker's discretion, and retirement income depends on the worker's account balance at retirement.

Today, more than 55 million American workers hold nearly $2.5 trillion in assets in more than 660,000 defined contribution plans.

We have witnessed a huge growth in defined contribution plans because they create significant benefits for both employers and employees. For employers, they are less burdensome and cheaper to administer. For employees, they provide more control and the opportunity for higher retirement income. Moreover, they are more portable so that employees with today's mobility in the work force can take assets with them when they change jobs.

Overall, defined contribution plans have been extremely successful, allowing millions of Americans to retire more comfortably than they otherwise could have. However, defined contribution plans do contain the risk that the contribution will not be invested to maximize return while minimizing risk. As a result, it is important to examine whether the law has successfully kept pace with the shift to defined contribution plans or whether adjustments to these plans are required.

An important issue has emerged in the context of these recent experiences, and that is the need for greater commitment to financial education. Indeed, when we look at the decisions that employees or workers as consumers need to make now, not only in the retirement area but in the health care field as well, educating workers about their options that allow them to make the right choices for their own specific circumstances is more important than ever before. Financial literacy will allow employees to make more sophisticated judgments about where and how to place their investments.

It is not the intention of this Committee to legislate based on isolated cases where the system has not worked but, rather, to look at whether and how the broad underlying fundamentals need correction. Therefore, this Committee will look at the current legal framework for defined contribution plans and examine reforms that help workers successfully save and invest for their retirement. That doesn't mean that the Committee on Ways and Means will not listen to and examine any current specific situations. The Subcommittee will be holding a series of hearings, both Oversight and other subcommittees, focusing on specific examples and allowing the Committee to look at the broader framework.

I look forward to learning more about the President's recommendations for retirement security and hearing from our panel of pension experts. Ultimately, we will hold a series of hearings, as I said, on retirement security to examine defined benefit pensions as well as defined contributions and Social Security and its solvency in the 21st century.

Prior to calling on the witnesses, I would recognize my colleague, the Ranking Member, the gentleman from New York, Mr. Rangel, for any opening statement he might have.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Hon. Bill Thomas, a Representative in Congress from the State of California, and Chairman, Committee on Ways and Means

Good afternoon. Today's examination of defined contribution pension plans is the first in a series of hearings that will allow the Ways and Means Committee to look at significant aspects of retirement security for America's workers.

Private pension plans are an important component of retirement savings for millions of Americans. Historically, most American workers were covered by "defined benefit" plans that provided a guaranteed benefit at retirement after a number of years of commitment, almost always at one company or corporation. However, over the last two decades we have seen an expansion in defined contribution pension plans. In a defined contribution plan, individual accounts are established for each worker and funded with either employer contributions, or employee contributions, or a mix of both. These contributions are usually invested at the worker's discretion, and retirement income depends on the worker's account balance at retirement. Today more than 55 million American workers hold nearly $2.5 trillion in assets in more than 660,000 defined contribution plans.

We have witnessed a huge growth in defined contribution plans because they create significant benefits for both employers and employees. For employers, they are less burdensome and cheaper to administer. For employees, they provide more control and the opportunity for higher retirement income. Moreover, they are more portable so that employees with today's mobility in the workforce can take assets with them when they change jobs.

Overall, defined contribution plans have been extremely successful, allowing millions of Americans to retire more comfortably than they otherwise could have. However, defined contribution plans do contain the risk that the contribution will not be invested to maximize return while minimizing risk. As a result, it is important to examine whether the law has successfully kept pace with the shift to defined contribution plans, or whether adjustments to the plan are required.

An important issue has emerged in the context of these recent experiences, and that is the need for a greater commitment to financial education. Indeed when we look at the decisions that employees or workers as consumers need to make now, not only in the retirement area but in the healthcare field as well, educating workers about their options that allow them to make the right choices for their own specific circumstances is more important than ever before. Financial literacy will allow employees to make more sophisticated judgments about where and how to place their investments.

It is not the intention of this Committee to legislate based on isolated cases where the system has not worked, but rather to look at whether and how the broad underlying fundamentals need correction.

Therefore, this committee will look at the current legal framework for defined contribution plans and examine reforms that help workers successfully save and invest for their retirement.

That doesn't mean that the Ways and Means Committee will not listen to and examine any current specific situation. Subcommittees will be holding a series of hearings, both Oversight and other subcommittees, focusing on specific examples and allowing the Committee to look at the broader framework.

I look forward to learning more about the President's recommendations for retirement security and hearing from our panel of pension experts. Ultimately we will hold a series of hearings, as I said, on retirement security to examine defined benefit pensions as well as defined contributions and Social Security and its solvency in the 21st century.

Mr. RANGEL. Thank you, Mr. Chairman.

I had initially thought, when it was suggested that this hearing was going to be on 401(k)s, that we would be dealing with the specific—I might as well say the word—the Enron situation, not because I think that this Committee should try to make a political statement out of this catastrophe, but because we have jurisdiction over pensions, oversight over 401(k)s, and I think it is safe to say that investors' confidence in this system has been eroded. The market has been negatively impacted. And it just seems to me that we have a responsibility to let the world know, at least let Americans know, that what has happened at Enron is not happening with every 401(k), not happening with every company, and that we are prepared to provide the oversight, and where we see a need for change, that this Committee is committed to do it and let the chips fall where they may.

But I guess this is just an overall review, and the more specifics will be handled by an Oversight Committee, and I think it is important enough, whenever the Chair decides to look at this thing specifically, that the whole Committee be involved.

I hope that the silence of this Committee is not mimicked by the Administration because a lot of people were hurt by the actions of probably a handful of people. And it just seems to me that the quicker we talk about it and the quicker the Administration emphasizes that we should correct what needs to be corrected, leave alone what is working, the quicker we can work as a team—not as Democrats and Republicans, but as people who are concerned about the 40 million workers that participate in these 401(k)s. And I don't think by just talking about non-specific and specific that we are fulfilling our obligation under the defined benefit or the defined contribution plan system.

As a matter of fact, there was a lot of talk about privatization of the Social Security system. It would seem to me that at some hearing or at some time we should find out what happens if the market is not working and do we provide some type of guarantee for those people that are involved with privatization of the Social Security system, or do we provide some security for those people with the 401(k)s.

This is so serious that I think that just by avoiding it, not talking about it, it is beginning to frighten me. I hope that the Administration has come prepared to talk about it and not to have us to believe that we can't even mention Enron.

And, Mr. Chairman, I think the quicker we just try to work an agenda together, the less political the agenda would be. But when I see this subject just being avoided by the Committee of jurisdiction, it just concerns me as to whether there is a deliberate effort to avoid this, especially since it just so happens that retirement benefits appears on our hearing schedule.

It seems to be inconsistent, but you haven't had time to discuss it with me, and I know that there is an explanation that would make a lot of sense when we get around to it. But I just want to thank you for this opportunity, and I will just wait to see which way the testimony comes from the Administration, and maybe they will be dealing with this more directly than you have.

Thank you.

[The opening statements of Mr. Crane and Mr. Camp follow:]

Opening Statement of the Hon. Phillip M. Crane, a Representative in Congress from the State of Illinois

Mr. Chairman, I appreciate the opportunity to submit my comments on this important issue. The Ways and Means Committee has taken bold steps in the last six months to modernize and improve the private pension system. In particular, the passage of the so-called Portman-Cardin bill provides increased opportunities for individuals to save for their retirement years. Likewise, a bill passed out of the Education and the Workforce Committee will give workers the opportunity to seek advice from outside financial experts so that they can adequately plan for their retirement. These two bills provide a powerful one-two punch in our continued efforts to make retirement plans more available, portable and stable.

On that note, I strongly encourage my colleagues to proceed with caution, as we look at new legislation that might impose increased regulatory burdens on employers. Time and time again throughout my service in Congress, I have seen us decimate various industries through over-regulation. We must be sensitive to the limited resources of employers or else, I'm afraid, that many will stop offering pension plans, 401(k)'s and employee stock-option plans altogether.

I look forward to working with my colleagues on the Committee as we continue to engage this important issue.

Opening Statement of the Hon. Dave Camp, a Representative in Congress from the State of Michigan

Today we are discussing protections for working Americans participating in Defined Contribution plans, especially the problems that arise where the employer controls the investment vehicle for the contribution. I want to make my colleagues aware of another growing trend, which threatens the retirement savings of American workers, both in 401(k) rollovers and IRA's.

There are some brokers who see the availability of 401(k) rollover and IRA money as an opportunity to enrich themselves. They prey on employees who have access to their defined contribution plans, either through job changes or retirement. These brokers advise investment of these sometimes sizable 401(k) and IRA roll-over accounts in risky schemes.

As we discuss protections for workers in defined contribution plans, we must look also look at what happens to that money once the employee leaves that company or retires. A major part of any retirement security solution must include security for these roll-over funds.

There is something simple we can do to help.

I have introduced a bill in the House, H.R. 1434, which reinstates the beneficial tax treatment of employer provided group legal services benefits to employees.

This simple mechanism can provide the necessary legal advice about investment vehicles. These independent attorneys can review documents and solicitations and explain to employees what they mean, before they invest.

If the employee needs a legal document such as a will or trust, to implement a retirement plan, the attorneys provide that. Of course group legal services allow employees access to justice for many other legal life events.

The area of retirement security and investment protection are prime examples of how readily available legal assistance serves an important need when an employee's financial well-being may be in jeopardy. I hope you will all join me in supporting this important piece of the retirement security puzzle.

I look forward to the testimony today about retirement security and defined contribution plans. Thank you.

Chairman THOMAS. Apparently the gentleman from New York did not fully appreciate the Chairman's statement when he said it was not the intention of this Committee to legislate based on isolated cases. That is, this hearing should not, in the Chair's opinion—and I hope in most Members' opinion—focus on Enron exclusively. There are 10 other committees in Congress focusing on that specifically.

To say that you can't mention something is rather ironic coming from that statement that we shouldn't focus on isolated cases, that we want to make sure in a broader sense the problems are introduced, not just one particular company's example of that. But if the gentleman wishes to make a case that we are somehow trying to avoid that, he completely misunderstands the Chairman's intention of not legislating based on isolated cases; rather, we should look at the broad success and occasional failure in an attempt to write legislation. That is the entire import of the Chairman's direction. If the gentleman wants to dwell on any one company, he certainly has the right to do so as a Member of the Committee. I indicated that we are going to have a follow-up where we can have small business, large business, employers, employees go in-depth into that issue so that those who are going to have to move legislatively from a Subcommittee have a greater opportunity to hear particulars.

The full Committee is not going to be able to investigate each and every isolated case, and the Chair will repeat, there are 10 other committees of Congress currently plowing that same furrow. We will watch to see if they produce responsible conclusions that will allow us in our job, as the gentleman indicates quite clearly, in overseeing retirement plans, and we hope that there will be some light generated by the other committees in assisting this Committee in moving forward.

And, with that, the Chair is pleased to recognize the Honorable Mark Weinberger, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, and Ann Combs, Assistant Secretary, Pension and Welfare Benefits, of the U.S. Department of Labor. You have submitted written testimony. It will be made a part of the record. And you can address us any way you see fit in the time you have available. The microphones have to be turned on, and they are very unidirectional, until we change the sound system in this wonderful but somewhat antiquated hearing room.

STATEMENT OF THE HON. MARK WEINBERGER, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. WEINBERGER. Thank you, Mr. Chairman, Congressman Rangel, and distinguished Members of the Committee, again, for inviting me to appear here before you.

As you are aware, certain recent tragic 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.

The Members of this Committee have always been serious proponents of the improvement of the retirement system for American workers, retirees, and families. Mr. Portman and Mr. Cardin have led the way in promoting retirement legislation. Their efforts over the last few years resulted in retirement legislation that had overwhelming bipartisan support in the House of Representatives. Most of the provisions in the retirement bill enacted last year as part of EGTRRA or Economic Growth and Tax Relief Reconciliation Act of 2001 were also included in earlier bills by Congressmen Portman and Cardin. We thank you for your leadership.

But there are many more Members of this Committee who have also led the way when it comes to expanding and protecting retirement security. Mr. Johnson is one of those leaders both by using his position on this Committee and as the Chairman of the Employer-Employee Relations Subcommittee of the Education and Workforce Committee. Mr. Neal has also shown great interest in retirement savings over the years. Both Mr. Weller and Mr. Matsui have been champions for greater disclosure to participants when employers change plan formulas. Mr. Ramstad has been a strong proponent of employee stock ownership plans (ESOP). Ms. Dunn has been an advocate of retirement issues, especially as they related to women. Mr. Pomeroy has a longstanding interest in retirement policy, especially the revitalization of the defined benefit plan. Mr. Rangel has demonstrated interest in solving some of the problems that have arisen in the defined contribution world. And finally, you, Mr. Chairman, have been a long-time sponsor of legislation that expands retirement savings through the use of IRAs or individual retirement accounts. We at Treasury appreciate all of your efforts.

Chairman THOMAS. Now, Mr. Weinberger, you have our attention.

[Laughter.]

Mr. WEINBERGER. At the outset, we must recognize that the issues relating to promoting and protecting retirement savings can be difficult and the proper balance hard to strike. 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 businesses prosper. As we explore added protections and new rules, 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 them. On the other hand, we must do what we can to ensure that workers have adequate protections and information to make informed decisions.

The general rules governing qualified plans were established in the Employee Retirement Income Security Act 1974 (ERISA). The special tax treatment accorded deferred compensation plans is intended to encourage employers to establish retirement plans for their employees.

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 extensive rules protecting participants and restricting the use of assets.

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

A defined benefit plan provides a participant with a defined benefit that is set out in the plan. 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 goes bankrupt, the Pension Benefit Guaranty Corporation (PBGC) provides a guarantee of benefits up to a statutory maximum.

In a defined contribution plan, the employer makes a contribution that is allocated to participants' accounts under an allocation formula specified by the plan. Earnings increase the participant's ultimate retirement benefit; losses decrease the 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 variety of investments. If a participant has the ability to direct plan investments, his or her investment decisions will determine the ultimate retirement benefit.

Employees and employers both appreciate many of the advantages of defined contribution plans. Employees have become more mobile and defined contribution benefits are often more valuable than defined benefits for employees who change employers during their working life.

A popular feature in defined contribution plans is the cash or deferred arrangement, referred to as the 401(k). Section 401(k) of the Tax Code permits a participant to elect to contribute, on a pre-tax basis, to a defined contribution plan instead of receiving cash compensation. Employer-matching contributions are often used to give an incentive to lower-paid employees to contribute to the plan.

The combined web of retirement vehicles, despite their complexities, has proven very successful. In 1998, qualified retirement plans for private employers covered 41 million defined benefit participants and 58 million defined contribution participants. These plans hold $4 trillion in assets. Currently it is estimated that 42 million workers participate in 401(k) savings plans and hold $2 trillion in assets.

As the 42 million 401(k) participants carry more and more responsibility for their retirement security, full confidence in the security of their pension plan is essential. Too many of these workers lack adequate access to investment advice and useful information on the status of their investment in 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.

With this in 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 will increase workers' ability 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 3 years.

Second, the President's proposal addresses the concerns regarding "blackout 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 company stock during times when workers are unable to trade in their 401(k) plans. As a matter of principle, the interest of executive officers and rank-and-file employees in a company should be aligned.

The proposal also clarifies that employers have a fiduciary responsibility for workers' investments during a blackout period.

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

Finally, in order for employees to get the investment advice that they need, the President advocates the enactment of the Retirement Security Advice Act—which passed the House with overwhelming support. The legislation encourages employers to make investment advice more widely available to workers and only allows qualified financial advisers to offer advice if they agree to act solely 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.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Weinberger follows:]

Statement of the Hon. Mark Weinberger, Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Mr. Chairman, Congressman Rangel and distinguished Members of the Committee, I thank you for the opportunity to testify before the Ways and Means 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 for American workers, retirees, and their families. Mr. Portman and Mr. Cardin have lead the way in promoting retirement legislation. Their efforts over the last few years resulted in retirement legislation that had overwhelming bipartisan support in the House of Representatives. 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. Thank you for your leadership.

There are many more members of this Committee who also lead the way when it comes to expanding and protecting American retirement security. Mr. Johnson is one of those leaders both by using his position on this Committee and as the Chairman of the Employer-Employee Relations Subcommittee of the Education and the Workforce Committee. Mr. Neal has always shown great interest in retirement savings over the years. Both Mr. Weller and Mr. Matsui have been champions for greater disclosure to participants when employers change plan formulas. Mr. Ramstad has been a great friend of employee stock ownership plans, especially when used by small business. Ms. Dunn has always been an advocate of retirement issues, especially as they relate to women. She was a passionate proponent of the catch-up contribution, which is now available to those over age 50. Mr. Pomeroy, although new to this Committee, has a longstanding interest in retirement policy, especially the revitalization of the defined benefit plan. Mr. Rangel has demonstrated interest solving some of the problems that have arisen in the defined contribution world. And finally, you, Mr. Chairman, have been a long-time sponsor of legislation that expands retirement savings through the expansion of IRAs. We at Treasury appreciate all of your efforts in this area.

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 House of Representatives 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.

[1] For example, EGTRRA provided a small business tax credit for qualified plan contributions and 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.

---

[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.

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

[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 rules of the Code.

terly statements are required. In addition, the quarterly statement should address 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.

Chairman THOMAS. Thank you, Mr. Weinberger. Secretary Combs?

STATEMENT OF THE HON. ANN L. COMBS, ASSISTANT SECRETARY, PENSION AND WELFARE BENEFITS ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Ms. COMBS. Good morning, Chairman Thomas, Ranking Member Rangel, and Members of the Committee. At the beginning I would like to associate myself with Mr. Weinberger's gracious comments to the Committee on your hard work in this area.

I appreciate the invitation to appear before you today to discuss developments in the private pension system and the President's plan to enhance workers' retirement security. The Administration looks forward to working with this Committee, especially those Members who have already introduced legislation to address these serious issues, such as Mr. Portman, Mr. Cardin, Mr. Johnson, Mr. Rangel, and Mr. English.

Today's hearing is especially timely because it is being held on the eve of the 2002 National Summit on Retirement Savings mandated by the Savings Are Vital to Everyone Act of 1997 or SAVER Act. This important event will develop recommendations to encourage Americans to increase their retirement savings and to improve financial literacy. I am grateful for the participation of several Members of this Committee in the summit, including Representatives Portman, Johnson, Cardin, and Pomeroy.

Our private pension system is a great success story. Today, more than 46 million American workers are earning retirement benefits with more than $4 trillion invested in the private pension system. The improvements championed by Representatives Portman and Cardin passed in the President's tax package last June will bring even more retirement savings opportunities to America's workers.

Recent events, however, have called the strength of our system into question. It is essential that we work together to restore Americans' confidence in our retirement system. We must be mindful of its voluntary nature and strike an appropriate balance that will improve retirement security while encouraging employers to offer plans and to make generous matching contributions.

The emergence of 401(k) plans over the past 20 years can be described as a virtual revolution in retirement savings. We now face the challenges of this revolution as we scrutinize the strengths and the weaknesses of defined contribution plans. 401(k) plans have—in a single generation—made America a nation of investors, but workers also bear the risks and the rewards of our economy in a much more personal way.

Participants in the vast majority of 401(k) plans today enjoy the freedom to make their own choices about how to invest their savings and plan for their own retirement. They also bear much of the responsibility for those choices. The Administration strongly believes that workers should be given more choice—not less—along with more control over and more confidence in their choices. More freedom, along with the tools necessary to make wise choices, is the best approach to equipping workers to plan for a secure retirement.

Let me turn now to a brief discussion of the President's plan to enhance retirement security by strengthening the rights of workers in defined contribution plans. On January 10th, President Bush formed a Task Force on Pension Security, appointing Secretaries Chao, O'Neill, and Evans to study this important issue. The Task Force tackled this project with the speed and the seriousness dictated by the importance of its mission. It was able to complete its work and issue recommendations in a very timely fashion, and I am pleased that we are here today to be able to discuss those with you.

On February 1st, the President announced his plan to give workers more choice in how to invest their retirement savings, the confidence in their investment decisions that comes from getting quarterly account information and reliable professional financial advice, and the same degree of control over their investments that corporate officers and executives enjoy.

The President's plan would increase workers' ability to diversify their retirement savings. We believe employers should continue to have the option to use company stock to make matching contributions. It is important to encourage employers to make as generous a contribution to workers' 401(k) plans as possible. However, workers also should have the freedom to choose how they wish to invest their retirement savings. The President's Retirement Security Plan will ensure that workers can sell company stock and diversify into other investment options after they have participated in the 401(k) plan for 3 years.

The President's plan would ensure that workers have adequate notice of an upcoming blackout period by requiring that employers give notice of the blackout at least 30 days before it begins. Workers deserve to know when a blackout period is expected and to have the opportunity to reallocate or change their investments, to apply for a loan, or to take a distribution in anticipation of the blackout if they believe that is the appropriate course of action for them.

We also suggest imposing rules that will encourage employers to make blackout periods as brief as possible. The President's plan would clarify ERISA to prohibit an employer from using section 404(c) of ERISA as a defense against a challenge that it breached its fiduciary duty during a blackout period, causing the participants to suffer losses as a result.

The 404(c) defense is based on the premise that plan participants have been given "control" over their investments in the plan. This shield from fiduciary responsibility should not be available during blackout periods when employers have suspended investment control from their workers.

But let me be clear. The President's plan would not hold employers liable for the rise and fall of investment values that occur during a blackout period because of market fluctuations. To bring a lawsuit against an employer under ERISA, a worker would still have to set and prove that a fiduciary breach occurred and that the worker's loss was caused by that breach.

Another element of the President's plan will further encourage employers to make blackout periods as brief as possible. Our proposal creates parity between senior executives and rank-and-file workers by restricting senior executives' ability to sell employer stock while workers are unable to change their 401(k) investments during a blackout period. The President believes it is simply unfair for workers to be denied the ability to sell stock held in their 401(k) accounts while senior executives do not face similar restrictions against selling company stock held outside the 401(k) plan. What is good for the shop floor is good for the top floor.

The President's plan also calls on the Senate to pass H.R. 2269, the Retirement Security Advice Act, which passed your Committee and the House with a strong bipartisan majority. This bill would encourage employers to make professional investment advice available to workers and allow qualified financial advisers to provide advice—if they agree to act solely in the interest of the workers in the plan and disclose any fees or relationships they have with the plan.

Finally, the Administration recognizes that workers deserve timely and complete information about their 401(k) plan investments. To enable them to make informed decisions, workers should be given quarterly benefit statements that include information about the value of their assets, the right to diversify, and the importance of a diversified portfolio. The President's proposal explicitly allows the Secretary of Labor to tailor this requirement to meet the needs of small businesses.

This combination of access to professional investment advice, an increased ability to diversify, and quarterly benefit statements will give workers the tools, we believe, that they need to make sound investment decisions.

Taken together, the measures proposed by the President will give workers the choice, confidence, and control they need to protect their savings and plan for a secure retirement. Workers deserve the chance to make unrestricted investment decisions, the confidence that comes from good information and professional investment advice, and a level playing field that gives them control over their retirement earnings.

As the President said in his State of the Union address, a good job should lead to security in retirement.

Thank you for giving me the opportunity to address this important subject today. We look forward to working with the Committee to ensure greater retirement security for all Americans. Thank you.

[The prepared statement of Ms. Combs follows:]

Statement of the Hon. Ann L. Combs, Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor

Introductory Remarks

Good morning Chairman Thomas, Representative Rangel, and Members of the Committee. Thank you for inviting me here today to share information about the Department's role in enforcement and regulation under the Employee Retirement Income Security Act (ERISA). Over the past 28 years, ERISA has fostered the growth of a voluntary, employer-based benefits system that provides retirement security to millions of Americans. I am proud to represent the Department, the Pension and Welfare Benefits Administration (PWBA), and its employees, who work diligently to protect the interests of plan participants and support the growth of our private pension and health benefits system.

Recent events have heightened concern about our private pension system, especially the defined contribution system. The Department has been working diligently to evaluate current law and regulations, and has consulted extensively with the President's domestic and economic policy teams on how to improve and strengthen the pension system.

Although some reforms are necessary, we should not presume that the private pension system is irreparably "broken." In fact, the private pension system is a great success story. Just two generations ago, a "comfortable retirement" was available to just a privileged few; for many, old age was characterized by poverty and insecurity. Today, thanks to the private pension system that has flourished under ERISA, the majority of American workers and their families can look forward to spending their retirement years in relative comfort. Today, more than 46 million Americans are earning pension benefits on the job. More than $4 trillion is invested in the private pension system. This is, by any measure, a remarkable achievement.

As employers move toward greater use of "defined contribution" retirement plans, such as 401(k) plans, we must nurture and protect employee choice, confidence and control over their investments. I welcome this opportunity to work with the Ways and Means Committee, and recognize the leadership you provide in protecting workers' pension assets, in raising necessary questions about the Enron situation and similar cases, and formulating policy to strengthen this country's retirement system.

My testimony will describe ERISA's background and regulatory framework; the trend towards greater use of "defined contribution" retirement plans and what that means for employers and employees; the Department's role in enforcing ERISA and providing assistance to employees and their families; the Department's actions regarding the Enron bankruptcy; and the President's Retirement Security Plan to improve our current laws to ensure retirement security for all American workers, retirees and their families.

ERISA

The fiduciary provisions of Title I of ERISA, which are administered by the Labor Department, were enacted to address public concern that funding, vesting and management of plan assets were inadequate. ERISA's enactment was the culmination of a long line of legislative proposals concerned with the labor and tax aspects of employee benefit plans. Since its enactment in 1974, ERISA has been strengthened and amended to meet the changing retirement and health care needs of employees and their families. The Department's Pension and Welfare Benefits Administration is charged with interpreting and enforcing the statute. The Office of the Inspector General also has some criminal enforcement responsibilities regarding certain ERISA covered plans.

Under ERISA, the Department has enforcement and interpretative authority over issues related to pension plan coverage, reporting, disclosure and fiduciary responsibilities of those who handle plan funds. Additionally, the Labor Department regularly works in coordination with other state and federal enforcement agencies including the Internal Revenue Service, Federal Bureau of Investigation, and the Securities and Exchange Commission. Another agency with responsibility for private pensions is the Pension Benefit Guaranty Corporation, which insures defined-benefit pensions.

ERISA focuses on the conduct of persons (fiduciaries) who are responsible for operating pension and welfare benefit plans. Such persons must operate the plans solely in the interests of the participants and beneficiaries. If a fiduciary's conduct fails to meet ERISA's standard, the fiduciary is personally liable for plan losses attributable to such failure.

Trends in Pension Coverage

There are two basic categories of pension plans—defined benefit and defined contribution. Defined benefit plans promise to make payments at retirement that are determined by a specific formula, often based on average earnings, years of service, or other factors. In contrast, defined contribution plans use individual accounts that may be funded by employers, employees or both; the benefit level in retirement depends on contribution levels and investment performance.

Over the past 20 years, the employment-based private pension system has been shifting toward defined contribution plans. The number of participants in these plans has grown from nearly 12 million in 1975 to over 58 million in 1998. Over three-fourths of all pension-covered workers are now enrolled in either a primary or supplemental defined contribution plan. Assets held by these plans increased from $74 billion in 1975 to over $2 trillion today.

Most of the new pension coverage has been in defined contribution plans. Nearly all new businesses establishing pension plans are choosing to adopt defined contribution plans, specifically 401(k) plans. In addition, many large employers with existing defined benefit plans have adopted 401(k)s and other types of defined contribution plans to provide supplemental benefits to their workers.

Most workers whose 401(k) plans are invested heavily in company stock have at least one other pension plan sponsored by their employer. Just 10 percent of all company stock held by large 401(k) plans (plans with 100 or more participants) was held by stand-alone plans in 1996; the other 90 percent was held by 401(k) plans that operate alongside other pension plans, such as defined benefit plans covering the same workers.

Although there has been a shift to defined contribution plans, defined benefit plans remain a vital component of our retirement system. Under defined benefit plans, workers are assured of a predictable benefit upon retirement that does not vary with investment results.

The trends in the pension system are a reflection of fundamental changes in the economy as well as the current preferences of workers and employers. The movement from a manufacturing-based to a service-based economy, the growth in the number of families with two wage earners, the increase in the number of part-time and temporary workers in the economy, and the increased mobility of workers has led to the growing popularity of defined contribution plans.

Employers' views have similarly changed. Increased competition and economic volatility have made it much more difficult to undertake the long-term financial commitment necessary for a defined benefit pension plan. Many employers perceive defined contribution plans to be advantageous while workers have also embraced the idea of having more direct control over the amount of contributions to make and how to invest their pension accounts.

Emerging trends in defined contribution plans and workers' job mobility make it increasingly important that participants receive timely and complete information about employment-based pension and welfare benefit plans in order to make sound retirement and health planning decisions.

Employer Securities Under ERISA

The investment of pension funds in the securities of a sponsoring employer is specifically addressed by ERISA. ERISA generally requires that pension plan assets be managed prudently and that portfolios be diversified in order to limit the possibility of large losses. Indeed, under ERISA, traditional "defined benefit" pension plans are generally allowed to invest no more than 10 percent of their assets in employer securities and real property. However, ERISA includes specific provisions that permit individual account plans like 401(k) plans to hold large investments in employer securities and real property, with few limitations.

As a separate matter, employee stock ownership plans (ESOPs) are eligible individual account plans that are designed to invest primarily in qualifying employer securities. Congress also has provided a number of tax advantages that encourage employers to establish ESOPs. By statutory design, ESOPs are intended to promote worker ownership of their employer with the goal of aligning worker and employer interests. By statute, they must be designed to invest more than 50 percent of their assets in employer stock. On average, ESOPs held approximately 60 percent in employer securities in 1996.

The legislative history of ERISA provides us with some of the rationale behind these exceptions to the rules regarding diversification. First, Congress viewed individual account plans as having a different purpose from defined benefit plans. Also, Congress noted that these plans had traditionally invested in employer securities.

In 1997, Congress amended ERISA to limit the extent to which a 401(k) plan can require workers to invest their contributions in employer stock. The rule generally limits the maximum that an employee can be required to invest in employer securities to 10 percent. The rule, however, does not limit the ability of workers to voluntarily invest in employer stock. Furthermore, the rule does not apply to employer matching contributions of employer stock or ESOPs.

Recent data indicate that 401(k) plans holding significant percentages of assets in employer securities tend to be very large, though few in number. Currently, almost 19 percent of all 401(k) assets, or about $380 billion, is invested in company stock. The distribution of holdings of employer securities is very uneven, however, with most 401(k) plans holding very small amounts or no employer stock. Fewer than 300 large plans (those with 100 or more participants), or just 0.1 percent of all 401(k) plans, invested 50 percent or more in company stock in 1996.

Because the plans heavily invested in company stock tend to be very large (with an average of 21,000 participants), the number of workers affected and the amount of money involved are substantial. In 1996, just 157 plans held $100 million or more in company stock. Together, these plans covered 3.3 million participants, and held $61 billion in company stock.

A great deal of the 401(k) money invested in company stock is under the control of workers. When participants can choose how to invest their entire account and company stock is an option, participants invest 22 percent of assets overall in company stock. However, when employers mandate 401(k) plan investments into employer stock, workers choose to direct higher portions of the funds they control into employer stock. In these plans, participants direct 33 percent of the assets they control into company stock.

If a 401(k) plan provides workers with the right to direct their account investments, and the plan is determined to have complied with section 404(c) of ERISA, then plan fiduciaries are relieved of liability regarding the consequences of participants' investment choices. The Department's Section 404(c) regulations are designed to ensure that workers have meaningful control of their investments. Among other things, employees must be able to direct their investments among a broad range of alternatives, with a reasonable frequency, and must receive information concerning their investment alternatives.

PWBA Actions: Immediate Reponse to Enron

We are bringing to bear our full authority under the law to provide assistance to workers affected by situations such as the recent Enron bankruptcy.

The Department of Labor has made a concerted effort to respond rapidly to situations such as Enron. In these circumstances, there are two aspects to our efforts: to help the workers whose benefits may be placed at risk and to conduct an investigation to determine whether there has been any violation of the law.

On November 16, 2001, over two weeks before Enron declared bankruptcy, the Department launched an investigation into the activities of Enron's pension plans. Our investigation is fact intensive with our investigators conducting document searches and interviews. The investigation is examining the full range of relevant issues to determine whether violations of ERISA occurred, including Enron's treatment of their recent blackout period.

Blackout periods routinely occur when plans change service providers or when companies merge. Such periods are intended to ensure that account balances and participant information are transferred accurately. Blackout periods will vary in length depending on the condition of the records, the size of the plan, and number of investment options. While there are no specific ERISA rules governing blackout periods, plan fiduciaries are obliged to be prudent in designing and implementing blackout periods affecting plan investments.

In early December, it became apparent that Enron would enter bankruptcy. Because the health and pension benefits of workers were at risk, we initiated our rapid response participant assistance program to provide as much help as possible to individual workers.

On December 6 and 7, 2001, the Department, working directly with the Texas Workforce Commission, met on-site in Houston with 1200 laid-off employees from Enron to provide information about unemployment insurance, job placement, retraining and employee benefits issues. PWBA's staff was there to answer questions about health care continuation coverage under COBRA, special enrollment rights under HIPAA, pension plans, how to file claims for benefits, and other questions posed by the employees. We also distributed 4500 booklets to the workers and Enron personnel describing employee benefits rights after job loss, and provided Enron employees with a direct line to our benefit advisors and to nearby One-Stop reemployment centers. These services were made available nationwide to other Enron locations.

PWBA regularly works throughout the country to assist employees facing plant closings, job loss or a reduction in hours, and subsequent loss of employee benefits. Our regional offices make it a top priority to offer timely assistance, education and outreach to dislocated workers.

I am pleased to announce that we have just activated a new Toll Free Participant and Compliance Assistance Number, 1–866–275–7922 for workers and employers to make inquiries regarding their retirement and health plans and benefits. The Toll Free Number is equipped to accommodate English, Spanish, and Mandarin speaking individuals. Callers will be automatically linked to the PWBA Regional Office servicing the geographic area from which they are calling. Benefits Advisors will be available to respond to their questions, assist workers in understanding their rights or obtaining a benefit, and assist employers or plan sponsors in understanding their obligations and obtaining the necessary information to meet their legal responsibilities under the law. Callers may also access our publications hotline through this number or they may access them on the PWBA website. Some of the publications available are: *Pension and Health Care Coverage—Questions & Answers for Dislocated Workers, Protect Your Pension, Health Benefits Under COBRA,* and many more. Workers and employers may also submit their questions or requests for assistance electronically to PWBA through our website, www.askpwba.dol.gov.

PWBA Benefits Advisors also provide onsite assistance in conjunction with employers and state agencies to unemployed workers—conducting outreach sessions, distributing publications, and answering specific questions related to employee benefits from workers who are facing job loss. In FY 2001, we participated in onsite outreach sessions for workers affected by 140 plan closings. So far this year, we have participated in 106 rapid response events reaching nearly 40,000 workers.

The Rapid ERISA Action Team (REACT) enforcement program is designed to assist vulnerable workers who are potentially exposed to the greatest risk of loss, such as when their employer has filed for bankruptcy. The new REACT initiative enables PWBA to respond in an expedited manner to protect the rights and benefits of plan participants. Since introduction of the REACT program in 2000, we have initiated over 500 REACT investigations and recovered over $10 million dollars.

Under REACT, PWBA reviews the company's benefit plans, the rules that govern them, and takes immediate action to ascertain whether the plan's assets are accounted for. We also advise all those affected by the bankruptcy filing, and provide rapid assistance in filing proofs of claim to protect the plans, the participants, and the beneficiaries. PWBA investigates the conduct of the responsible fiduciaries and evaluates whether a lawsuit should be filed to recover plan losses and secure benefits.

In certain cases, PWBA may seek the appointment of an independent fiduciary to manage a retirement plan even before an investigation is completed, particularly if the plan sponsor has filed for bankruptcy. We initiated negotiations in January with Enron to secure the removal of the Administrative Committees for Enron's pension plans. The Administrative Committees are made up of Enron officials who serve as plan fiduciaries with responsibility for operating and managing the plans and protecting the rights of participants and beneficiaries. Our objective is to replace them with an independent fiduciary, expert in ERISA and experienced in protecting the interests of participants and beneficiaries in complex pension plans like Enron's. On February 13, Secretary Chao announced an agreement with Enron to appoint an independent fiduciary to replace the Enron pension plans' Administrative Committees, and for Enron to pay up to $1.5 million per year for those services. We are working to name a qualified independent fiduciary as soon as possible.

Our investigation of Enron was begun under REACT. Because I do not want to jeopardize our ongoing Enron investigation, I cannot discuss the details of the case. Without drawing any conclusions about Enron activities, I will attempt to briefly describe what constitutes a fiduciary duty under ERISA, how that duty impacts on investment in employer securities, the duty to disclose, and the ability to impose blackout periods.

Determining whether ERISA has been violated often requires a finding of a breach of fiduciary responsibility. Fiduciaries include the named fiduciary of a plan, as well as those individuals who exercise discretionary authority in the management of employee benefit plans, individuals who give investment advice for compensation, and those who have discretionary responsibility for administration of the pension plan.

ERISA holds fiduciaries to an extremely high standard of care, under which the fiduciary must act in the sole interest of the plan, its participants and beneficiaries, using the care, skill and diligence of an expert—the "prudent expert" rule. The fiduciary also must follow plan documents to the extent consistent with the law. Fiduciaries may be held personally liable for damages and equitable relief, such as disgorgement of profits, for breaching their duties under ERISA.

While a participant or beneficiary can sue on their behalf of the plan, the Secretary of Labor can also sue on behalf of the plan, and pursue civil penalties. We have 683 enforcement and compliance personnel and 65 attorneys who work on ERISA matters. In calendar year 2001, the Department closed approximately 4,800 civil cases and recovered over $662 million. There were also 77 criminal indictments during the year, as well as 42 convictions and 49 guilty pleas.

President Bush's Plan

In January, President Bush formed a task force on retirement security and asked Labor Secretary Chao, Treasury Secretary O'Neill and Commerce Secretary Evans to analyze our current pension rules and regulations and make recommendations to ensure that people are not exposed to losing their life savings as a result of a bankruptcy. In his State of the Union speech, the President reiterated his commitment to improving the retirement security of all Americans.

The President's Retirement Security Plan, announced on February 1, would strengthen workers' ability to manage their retirement funds more effectively by giving them freedom to diversify, better information, and access to professional investment advice. It would ensure that senior executives are held to the same restrictions as American workers during temporary blackout periods and that employers assume full fiduciary responsibility during such times.

Under current law, workers can be required to hold company stock in their 401(k) plans for extended periods of time, often until they reach a specified age. Workers lack the certainty of advance notice of blackout periods when they cannot control their accounts, lack access to investment advice and lack useful information on the status of their retirement savings. The President' Retirement Security Plan will provide workers with confidence, choice and control of their retirement future.

The President's plan would increase workers' ability to diversify their retirement savings. The Administration believes employers should continue to have the option to use company stock to make matching contributions, because it is important to encourage employers to make generous contributions to workers' 401(k) plans. However, workers should also have the freedom to choose how they wish to invest their retirement savings. The President's Retirement Security Plan will ensure that workers can sell company stock and diversify into other investment options after they have participated in the 401(k) plan for three years.

The President is also very concerned about blackout periods, and the Retirement Security plan suggests changes to make blackout periods fair, responsible and transparent. Our proposal creates equity between senior executives and rank and file workers, by imposing similar restrictions on senior executives' ability to sell employer stock while workers are unable to make 401(k) investment changes. It is unfair for workers to be denied the ability to sell company stock in their 401(k) accounts during blackout periods while senior executives do not face similar restrictions with regard to the sale of company stock not held in 401(k) accounts. Because the oversight of stock transactions of senior executives may go beyond the jurisdiction of the Department of Labor's regulation of pension plans, I will work with the appropriate agencies to develop equitable reform.

The President's Retirement Security Plan ensures that workers will have ample opportunity to make investment changes before a blackout period is imposed by requiring that they be given notice of the blackout period 30 days before it begins. Although employers regularly give advance notice of pending blackout periods, an explicit notice provision will give workers assurance that they will know when a blackout period is expected.

As my testimony stated, ERISA may limit the liability of employers when workers are given control of their individual account investments. The President's Retirement Security Plan would amend ERISA to ensure that when a blackout period is imposed and participants are not in control of their investments, fiduciaries will be held accountable for treating their workers' assets as carefully as they treat their own. Of course, employees would still have to prove that the employer breached a fiduciary duty in order to seek damages.

The President's plan calls on the Senate to pass H. R. 2269—the Retirement Security Advice Act—which passed the House with an overwhelming bipartisan majority. We believe it is important to promote providing professional advice for workers. The bill would encourage employers to make investment advice available to workers and allow qualified financial advisers to offer advice if they agree to act solely in the interests of the workers they advise. Partnered with the proposed increased ability for workers to diversify out of employer stock, investment advice services will be more critical than ever.

Finally, the Administration recognizes that workers deserve timely information about their 401(k) plan investments. To enable workers to make informed decisions, the President's Retirement Security Plan will require employers to give workers quarterly benefit statements that include information about their individual accounts, including the value of their assets, their rights to diversify, and the importance of maintaining a diversified portfolio. The Secretary of Labor would be given authority to tailor this requirement to the needs of small plans. Again, in combination with investment advice and the ability to diversify, quarterly, educational benefit statements will give workers the tools they need to make sound investment decisions.

Conclusion

The private pension system is essential to the security of American workers, retirees and their families. While the current scrutiny is appropriate and welcome, we must strengthen the confidence of the American workforce that their retirement savings are secure. The challenge before us today is to strengthen the system in ways that enhance its ability to deliver the retirement income American workers depend on. We must accomplish this without unnecessarily limiting employers' willingness to establish and maintain plans for their workers or employees' freedom to direct their own savings. The President's Retirement Security Plan strikes just such a balance.

We look forward to working with Members of this Committee in continuing this discussion and in developing ways to achieve greater retirement security for all Americans.

Chairman THOMAS. Thank you.

If we are going to be talking about defined contribution pension plans, or the so-called Tax Code section 401(k), you mentioned the term, workers ought to be able to "diversify." It is pretty obvious that one of the things that employers or employees could put into these retirement plans is cash. Right? You put in dollar amounts. But if you can also put stocks, are there any other things that employers or employees could put into 401(k) plans: gold coins or rare paintings?

Mr. WEINBERGER. The answer is no, Mr. Chairman.

Chairman THOMAS. All right. Then why was it created to do just money and stocks? And how many companies do just money or how many companies do just stock, or a combination of either?

Ms. COMBS. I am sorry, Mr. Chairman. We were getting some clarification. Apparently real property is also—qualifying employer real property and real property generally is also a permitted contribution to a 401(k)-type plan as well.

Chairman THOMAS. My assumption is that is not very often.

Ms. COMBS. I think that is a good assumption.

Mr. WEINBERGER. One of the apparent issues that was raised early on was you want to put assets into plans that are relatively easy to value. And so publicly traded stock, certainly cash—I don't know how employer-provided property got in there, but once you move down the line of things where you are putting any kinds of assets in there, it becomes more difficult.

Chairman THOMAS. So we are basically looking at a universe of 401(k)s containing either dollar contributions, employer stock, or the employee then diversifying, i.e., going into other assets that could be easily determined, stock or other items.

Do we know roughly how many companies use the stock option versus companies that use dollars?

Ms. COMBS. The data is hard to come by, actually, on how many actually make the matching contribution in employer stock. On average, 401(k) plans hold about 19 percent of their assets in employer stock, but it really is very heavily skewed toward large plans. If you look at——

Chairman THOMAS. But an employee could purchase the company's stock that they work for, so that really doesn't tell you how many companies use stock.

Ms. COMBS. That is correct. That is what I was saying. The data on how many make matches in employer stock is more difficult to come by.

We, the Department of Labor, they don't report that to us. They don't break it out that way on the annual report they submit with us. We don't have that data.

Chairman THOMAS. The gentleman from Ohio?

Mr. PORTMAN. I think that is an excellent question, and we will get some follow-up here. But my understanding is that it is less than 1 percent of plans that offer corporate stock as a match. Some companies, of course, offer non-elective stock, which is not a match. Total assets in 401(k)s is roughly 10 percent in terms of the match because, as Ms. Combs said, it tends to be larger companies; therefore, larger plans. But I believe the number you are looking for would be less than 1 percent. In fact, I think it is less than one-half of 1 percent.

Chairman THOMAS. So, clearly, most corporations, when they participate in a 401(k) plan with an employee, do it on a cash contribution basis, and then the employee makes decisions as to what the holdings are.

I want to try to get a feel for just how extensive the stock as the employer's contribution is, and if the data is correct, it is like 1 percent.

Both of you indicated that the President was talking about making changes, and clearly, if there are so-called blackout periods where decisions are removed from supposedly the owner of the asset, the employee, there could be games played in blackout periods. And recent examples indicate maybe the decisions that didn't need to be made could have been made to allow for a blackout period. I applaud you in terms of making sure that you have no games. Transparency on a blackout period, prior notification are all good ways to make sure games aren't played.

The way you put it, what is good for the shop floor is good for the top floor in terms of handling stock outside of a 401(k) is a good idea as well. I think most people are going to focus on the controls the Administration advocates over decisions made by both the company and the individuals in the 401(k).

You indicated that there was a timeframe that the President is requesting of 3 years. Three years to do what? What are the options that are restricted during the 3-year period, and what can you do after the 3-year period in terms of diversification of company stock?

Mr. WEINBERGER. In the President's proposal, the employer would not be able to require the employee to hold employer stock after a 3-year period of participation in the plan. Obviously, the employer can allow the employee to, any time before that, diversify. But the 3-year period, which about marries up with the 3-year vesting rule, is the time period that the President has chosen.

Chairman THOMAS. And do some companies require that employees, if stock is part of the 401(k), hold for a longer period than that?

Ms. COMBS. Yes. Under current law, it is really up to the employer on how they design the plan. Many employers offer employees the ability to diversify immediately. Others can restrict the ability to sell out of employer stock.

The one rule is that if it is an ESOP, you have to allow people to begin diversifying when they turn age 55 and they have 10 years of participation in the plan.

Chairman THOMAS. Do some employers offer stock to employees at less than market prices, i.e., at a discount?

Ms. COMBS. Generally not in a qualified plan. They could offer stock purchase plans, but those are really a form of executive compensation that is not generally covered under ERISA. But in a qualified plan, the contributions are made at the market value.

Chairman THOMAS. But under a 401(k), then why should there be any restriction if, in fact, it is like an arm's-length business arrangement? If there is no discount to the stock, why shouldn't an employee be able to make a decision at any time that they receive it?

Ms. COMBS. Well, we were trying to strike a balance between encouraging employers to make generous matching contributions, and there are reasons through the Tax Code—I will defer to Mark on that—and reasons of trying to retain employee loyalty and align the interests of the workers and the firm, that people want to have their workers invested in employer stock.

Our fear was if we had immediate diversification, you might see a dropoff in the level of matching contributions. We thought 3 years struck a reasonable balance because, as Mark said, that is generally the vesting period for plans, the point at which someone has demonstrated a real commitment to the firm.

Chairman THOMAS. Then, finally, I did not hear about the President's plan—and there has been a discussion and, in fact, legislation introduced—that beyond the holding period requirements, perhaps some percentage of company stock limitation within the 401(k) might be appropriate. I did not hear that as part of the President's plan. Is that correct?

Mr. WEINBERGER. That is correct, Mr. Chairman.

Chairman THOMAS. And why is it not there?

Mr. WEINBERGER. Well, as we outlined, the President's plan is designed to give the maximum level of choice to individuals, and so we thought that it was appropriate to provide that choice not to have the Federal government look in and have a one-size-fits-all—whatever the percentage might be—limitation or cap in the amount of employer-provided stock that could be in a plan. There are several reasons for that, not the least of which is that very often defined contribution plans are just part of an overall retirement benefit plan, and so there are lots of other assets within the retirement plan in a company or outside the company.

Moreover, depending upon how the cap is structured, it could create some anomalous results, such as that as the stock price goes up and you reach a certain percentage of the value of the amount in various plans, you can be forced to sell the stock, and as the stock goes down, buy it back. It is not necessarily the type of activity you would want to encourage. So there are definitely issues associated with that.

Chairman THOMAS. I think you are going to find that there are going to be a lot of questions surrounding both of those issues. And if there is some ability to create question-and-answer pages on both the holding period and on the rationale for not dealing with the percentage, that that will save a lot of time and energy. If the group did look at those questions, did decide the way they did, and looked at options and didn't carry them out, a Q&A might be very useful for us as we move forward on paper to allow us to quickly understand the decision matrix that wound up with the President's plan the way it is.

Does the gentleman from New York wish to inquire?

Mr. RANGEL. Thank you, Mr. Chairman.

I hope the record would indicate that Secretary Combs did not mention nearly as many Members favorably as did Secretary Weinberger.

[Laughter.]

Mr. WEINBERGER. Congressman Rangel, this is my 20th time here before the Committee. I wanted to make sure I was listened to this time, so I thought it might be helpful.

Mr. RANGEL. You are all right.

Secretary Combs, what I would like to see is where the employer has the maximum opportunity to invest in the private sector and maximize their returns, and at the same time have the security of knowing that they have a protected pension fund. Is that possible?

Ms. COMBS. I think that is the right goal. We, too, agree that people need the maximum amount of flexibility and choice.

Mr. RANGEL. Where is the insurance? Without mentioning that firm that the Chairman mentioned——

Chairman THOMAS. What firm was that?

Mr. RANGEL. The E word. But, listen, I respect your decision, and I know that the Administration cannot comment because it is under investigation. That is all right, too. But if a similarly situated firm had someone investing up to what appeared what he thought was a million dollars for retirement, and then ended up with $5,000, they had all the flexibility in the world but somehow ended up with nothing.

I want to know—I don't want to have a goal. I want to know whether the Administration can say that what they want to do is to make certain that at the end of the retirement period that there is a pension fund that is going to be available for the faithful employee. Can you give any ideas where that thought could be guaranteed rather than having this as a goal and objective?

Ms. COMBS. I think one of the issues we have to grapple with is the balance between defined benefit and defined contribution plans.

Mr. RANGEL. I am okay with the defined benefit. There is a cap on what you are going to get, and, of course, there is a cap on the risk that is involved. The other is the American way. You take the risk, and I don't want to pay for—I don't want the worker to pay for choices that they made that were not appropriate choices.

Am I being too restrictive and dampening the American dream? I want to make certain that they get out there and do what they have to do, but at the end of the day, that they don't come back to the Federal government and ask for a handout. I want to make certain that they have a defined benefit, they have something there to take home. Or is this the type of thing that you take the risk and if at the end of the day you made bad choices, you have no pension?

Ms. COMBS. Well, I think, again, we both agree that defined benefit plans provide that guaranteed benefit and——

Mr. RANGEL. I want to get away from that because it is not popular with some of my colleagues. I want to go the route of privatization, go to the stock market, and do well, and not have a cap on the amount of money. I want a good economy. I want the employee to benefit from the good economy and not have a cap on the benefits. But I want to make certain that there is an insurance that they don't end up broke.

Ms. COMBS. Well, I think in a defined contribution plan, the promise is the contribution, and there is risk involved, depending on how you invest your portfolio. What we have tried to do, what the Administration's proposal would do, is to make sure that people aren't restricted in their ability, for instance, to diversify their accounts. Under the current law, you can end up in a situation where a significant portion of your retirement assets are tied up in a single——

Mr. RANGEL. Secretary Combs, I think some of the leaders in the Congress really want to get the government out of—out of a lot of things, out of health, out of education, out of Social Security. And the best way to do it is to tell them, Go out there and take the government out of it, let people do what they want. The less government, the better.

So here is an amount of money. Here are some options. Diversify, invest. And if you don't make it at the end of the day, then there are charities and there are other things. But, for God's sake, don't come back to the Federal Government. That is not our job to make—it is not like the ERISA things where there were goals and objectives for equity and fairness. The name of the game is you take the risk, you pay the price.

Ms. COMBS. But there are also rules of the game, and we do have fiduciary standards under ERISA which are a way to make sure that the rules are fair, that employers are responsible for the investment options that they offer, that they monitor those investment options.

Mr. RANGEL. But under the laws that we just passed, the person can have a conflict of interest, be an investor in the company and at the same time be accepted as the adviser to the employee. So, in a sense, for most workers—strike “most.” For a lot of workers, the cards are really stacked against them as to what they really know. You need professionals who know. And I don’t see where you have to go as far as Enron in violating a fiduciary responsibility. You just never know what is going to happen in the market.

I am just saying, could you devise some plan or think that it is possible or is it the right thing to say that there is going to be a guaranteed pension? True, there may be some restrictions. You can’t just roll the dice and put everything on one roll. But can you give some guarantee at the end of the day that the pension fund is going to be there? Can you avoid the Enron problem that we face today for employees?

Mr. WEINBERGER. Mr. Rangel, could I just add——

Mr. RANGEL. Yes.

Mr. WEINBERGER. Thank you. Obviously there are lots of—an overused phrase—legs to the stool of savings. In this situation, insurance is diversification. That is basically what an insurance vehicle is. We want to provide the tools to individuals, coupled with defined benefit plans and Social Security, which is the leg to help people who don’t have enough savings to be able to survive, and also to give them a benefit for when they retire and reach retirement age.

The defined contribution plan is a very important asset-building, wealth-generating tool. The average percentage return has been about 12 percent between 1990 and 1998 on assets in defined contribution plans going right to employees. That is a very good return, and it helps a lot of people who otherwise wouldn’t have the wherewithal to move up the ladder in the income to get those assets.

So the defined contribution plan is a wealth-generating, asset-building type of plan.

Mr. RANGEL. Mr. Secretary, I embrace all of the advantages of the plan. I want my cake and eat it, too. I want them to be able to do all of these things. But at the end of the day, I don’t want this person coming to the Federal Government and saying, “I lost.” I don’t want this Las Vegas approach to a pension plan, no matter how much latitude you give to the investor-employee. I want at the end of the day to know that there is something to take home and take care of their family. Is that possible? All you have to do is say no, you can’t do both, and I will have to accept that is the Administration’s position and try to work out something legislatively.

Is that a fact that you can’t give the employee all of these opportunities and expect at the end of the day that you are going to give them a guarantee, too?

Mr. WEINBERGER. I think that if you were to go ahead and provide a specific guarantee——

Mr. RANGEL. Yes.

Mr. WEINBERGER. Some sort of guaranteed return——

Mr. RANGEL. Insurance plan.

Mr. WEINBERGER. You would see the most probably aggressive investments possible so that people would not worry about any downside risk, and it would not be—the market would not function appropriately.

Mr. RANGEL. So what I am saying is unrealistic? You don't have to defend me. I mean, it is unrealistic to believe that you can play this game of defined contribution and still expect that you are going to get a defined benefit, no matter——

Mr. WEINBERGER. Let me give you this answer, Mr. Rangel. You can invest in private market insurance vehicles with guaranteed return, like Guaranteed Investment Contracts (GIC). So there is that ability right now to invest in government bonds or GICs and get a guaranteed return. GICs are the insurance company, GIC.

Ms. COMBS. You can invest in treasuries, you can buy an annuity. I do think it is a very difficult goal to achieve, because as Mr. Weinberger pointed out, you would create a moral hazard if you provide a government guarantee of investment return. People will have an incentive to make very aggressive investments knowing that if they don't pan out, there is a floor beneath them. It is more akin to kind of the S&L, savings and loans, situation, if you will, in an insurance program, if you design it wrong, than it is to the insurance program for defined benefit plans.

In that program, you are insuring against corporate failure. It is an insurable event that you can identify. There are funding rules in place that the players have to meet on an ongoing basis, and so it is a more discrete insurable event. Insuring against market risk in defined contribution plans really, I believe, would create a moral hazard, and it would be very difficult to do. And, you know, we want to work with the Committee to minimize risks people face in their retirement savings, but we need to do it with our eyes wide open and aware of the kind of incentives that you can create.

Chairman THOMAS. The gentleman's time has expired. Does the gentleman from Illinois wish to inquire?

Mr. CRANE. Yes, thank you, Mr. Chairman.

Mr Weinberger, there is some confusion regarding the diversification requirements in the Administration plan for ESOPs, ESOP with 401(k) feature (K–SOPs), and 401(k) plans. As you can imagine, I have a serious concern regarding Federal requirements on any private pension plan that forces an employer who voluntarily establishes a plan and makes voluntary contributions to diversify under a Federal law.

Could you please clarify the Administration's position on this matter?

Mr. WEINBERGER. Certainly, Mr. Crane. What the Administration proposes is that employers cannot restrict individuals from diversifying after 3 years of participation in any defined contribution, 401(k) plan. So obviously the employer has the ability to be able to require more rapid diversification, but the objective here is to balance between creating a situation where employers will still provide the benefit and giving the ability to individuals to have choice.

What we have done is separated out employee stock ownership plans that have no relation to 401(k)-type plans. ESOPs, which have been used in many cases traditionally as a vehicle for leveraged buyouts, retirements, things along those lines, where there no employer match, it is not tied to a 401(k) plan, are not subject to the diversification rules because they have a different purpose.

Chairman THOMAS. Does the gentleman from California, Mr. Matsui, wish to inquire?

Mr. MATSUI. Thank you very much, Mr. Chairman.

I want to thank you, Mr. Weinberger, and you, Ms. Combs, for being here today.

Obviously the issue of the 401(k)s, the whole issue of diversification, whether you go for a defined contribution approach rather than a defined benefit approach, and obviously the lockout issue, all three of those are very critical, and legislation has been introduced to deal with that. Obviously you have your own bill.

I wanted to move over from that for a minute because I think there is a more fundamental issue than how you make these changes on the 401(k) plan. I think the Enron example is one that probably was shared by a lot of the dotcoms as well, where you had ISOs, incentive stock options, that were given to employees that were not on the books. You had derivatives both for the dotcoms, particularly with companies like Enron. You had contracts that Enron had through partnerships that were not reflected appropriately on the balance sheets of the prospectus.

The real issue here, I think, is one of transparency, the fact that the Securities and Exchange Commission (SEC) and others really did not know the real financial status of Enron, nor did they know, many investors, the real financial status of many of those dotcoms that failed over the last 5 years.

What is the Administration thinking in that area? There has to be something you need to do in this area? I mean, we can fool around with a cap on the amount of investments. We can, you know, talk about diversification. We can talk about the lockout. We have to do all those things, obviously, because we find there are some problems there.

But what about the fundamental issue? What is the Administration going to do about these other areas to make sure that financial statements are accurate from now until whenever? Because I think that is really going to be the major issue for many investors, many of those employees that have these 401(k)s. And I think we are moving in that direction. I think this issue is very timely because we are moving away from defined benefits to defined contributions, and there are a lot of young people in their 20s, 30s, and 40s that might find themselves in trouble.

You mentioned, Mark, that, you know, over the last year the equity markets have gone up 12 percent through the defined contribution, but it depends upon when you retire, not over the 10-year period. And if you retire at the wrong time—when, for example, the Nasdaq went from 4,500 to 1,700—you got a problem on your hands.

So how do we deal with this fundamental issue of making sure financial statements are adequate? Because I think under the current situation you can manipulate the system in a way that literally billions of dollars could be hidden in terms of your losses.

Mr. WEINBERGER. Well, Mr. Matsui, it is obviously an excellent question, and today's issue is not meant to resolve all the issues surrounding Enron or other failures that have occurred. The President has set up another working group that is looking at these very issues which go to corporate disclosure. You might have seen the Secretary has been pretty outspoken with regard to responsibilities of directors and Chief Executive Officers (CEO).

That Task Force is made up of a number of people, including Members of the SEC, Mr. Pitt; my boss, the Secretary; Don Evans is on it, and others. And they are working to come up with a report to the President as well, and that will discuss a lot of the issues you are talking about.

Of course, we don't know—it is always hard to legislate good or bad doings, so to the extent——

Mr. MATSUI. If I may just interrupt, Mark, I am not suggesting we legislate on morality. I am just suggesting that some of these things that we have kept off the books—and we are as guilty as anyone else, because a lot of Members of Congress—I could name a few—and Senators who actually pushed the Administration, then the Clinton Administration, not to pursue some of these things that we are talking about.

Mr. WEINBERGER. There is a thorough review going on within the Administration of that Task Force. I am sure the SEC, as you all know, is also looking at it. And you are absolutely right. Sunshine is important for accountability, and we have seen some of the markets reacting to the uncertainty about what else may be out there. And the more we can do to get adequate disclosure and responsibility, I think we will all be better off.

Mr. MATSUI. When do you think this report or this Task Force is going to come up with its recommendations?

Mr. WEINBERGER. Mr. Matsui, I don't know. I know they are working with all due speed because of the importance of the issue, and I do expect that it won't be terribly long. But there is a whole host of interlocking issues, and you have lots of agencies involved in that type of situation. So they are working quickly to try and come up with recommendations.

Mr. MATSUI. When you say quickly, I mean, are we talking about the next month or two, or 2004? And I don't mean to—obviously you have no answer at this time, but—see, I don't want us to be diverted on the wrong issue. I think we can—it is going to be really easy to deal with the 401(k)s, I think. There are some problems, obviously, but we could probably deal with them. The big issue is whether we are going to be able to take on some of the big interests and deal with these other issues.

I would like to kind of get a sense—you know, maybe you could do this. Maybe you could get back to us on when you think the working group will come up with its recommendation on these other areas outside in terms of perfecting a balance sheet and providing transparency. Could you do that?

Mr. WEINBERGER. I will certainly check with the Secretary and try and get an answer for you.

Mr. MATSUI. If I may just—and I know my time has expired. Are you part of this working group, or are you, Ms. Combs?

Mr. WEINBERGER. No, I am not.

Mr. MATSUI. Who would be in the Administration working on this?

Mr. WEINBERGER. Well, Secretary O'Neill is on it, Secretary Evans, Mr. Pitt from the SEC.

Mr. MATSUI. Who is the Assistant Secretary that is actually managing this on a day-to-day or week-to-week basis? Do we happen to know?

Mr. WEINBERGER. Peter Fisher, who is the Under Secretary of Finance, will be working for it at Treasury.

Mr. MATSUI. Okay. And I know this isn't within our jurisdiction, but it is important.

Chairman THOMAS. No, the gentleman's point is very well taken. This Committee has moved forward and provided leadership in this difficult area.

What the Chairman hopes is that the Administration doesn't bog down in turf wars between departments or agencies in producing the document he is talking about. And I think that was implicit in the points that he was making.

We need as much sound advice as we can get. That is why I asked you for the Q&A sheets previously. The report would be very helpful to us, but if you are not going to be able to come to reasonable agreements within the administrative jurisdictional difficulties, you can imagine how hard it is going to be for the committees of Congress that have shared jurisdiction in this area.

This Committee has—and I am proud to say—under previous chairmen and under this one, we will lead where it is necessary to legislate. So I think the gentleman from California is telling you, if you have got something to provide to the legislative product, get it to us as quickly as you can. We will move forward. We would appreciate the benefit of your suggestions.

Mr. WEINBERGER. I will be happy to bring that back. I sense no—it is not a disagreement issue. It is just grappling with the difficult issues.

I forgot a very important Member of the Task Force; Chairman Greenspan from the Federal Reserve is also on that Task Force.

Chairman THOMAS. And we would like the recommendations in understandable English.

Mr. WEINBERGER. No comment.

Chairman THOMAS. Does the gentleman from Florida, Mr. Shaw, wish to inquire?

Mr. SHAW. Thank you, Mr. Chairman. Just one minute to further pursue Mr. Matsui's line of questioning, which I think was a very good line.

We as investors as well as government through the SEC are very dependent upon the certified public accountants of this country in certifying and giving their opinion with regard to financial statements that they audit, an important component in looking at the failure of a huge corporation which came as a complete surprise, and when we saw some of the things going on which shouldn't have been going on, and actually some financial dealings that were actually covering up tremendous losses and liabilities.

The big question you have to ask is: What did Arthur Andersen know and when did they know it? And I think this is something that all of this is going to have to come down to.

As a former certified public accountant myself, I can well understand exactly the problems. The American Institute of Certified

Public Accountants is probably one of the most respected—and for good reason—organizations in the entire world. We depend upon them for so much, and I think it is a question of going to them and talking to them about what they can do to be sure that we don't get in this trouble, in this bind again.

Also, in both 401(k)s as well as IRAs, I think the big question is diversification. Even when your employer is giving you a good deal on the stock, you should certainly know that you are putting all your eggs in that basket.

Mr. Rangel brought up the point about who is going to guarantee the benefits. Well, I don't think these pension plans are set up so that we are the guarantor. However, I would invite my very good friend Charlie to take a look at my Social Security reform package which does contain these guarantees, keeps the existing Social Security system totally in place without in any way interfering with any of the benefits or in any way invading the Social Security trust fund, but at the same time allows for individual retirement accounts with contributions directly from the U.S. Treasury into these in order to save Social Security for all time.

I would hope that we will recognize the power of investment in the private sector. This Committee, I think we only had one person to vote against taking the railroad funds out of treasury bills and putting them into these type of investments, and I think the only one that voted against it on this Committee was on the Republican side, not on the Democrat side. So I think all of us do recognize that you can get a much better return in the private sector.

We have to be careful not to get stampeded into destroying a system that is working very well just because we have some significant failures, when you see that the economy and this type of investment you have to view over a long period of time, people in these type of investments have to plan for their retirement and a few years out start thinking about going more into bonds and treasury bills than corporate stocks in order to be able to project with some certainty exactly what their retirement is going to be.

There are going to be ups and downs in the market. There is no question about that, and I think we all have to be very much aware of that. But when you look over the last 75 years, which goes through a depression and world war and several other wars, you see that you have done a lot better investing in corporate America than investing in U.S. Treasury bills, as the present Social Security system is required to do.

So we need to add something onto Social Security in order to make it grow, because we do know we are going to be running out of money in Social Security. Social Security will not have the funds through the Federal Insurance Contributions Act (FICA) taxes to pay the benefits commencing in 2016. It is that simple. And we are going to have to start cashing in those Treasury bills, which we have already been told by Greenspan and others who have come before this Committee, including the former Administrator of Social Security, that Treasury bills held by the government and issued by the government are not real economic assets. We have to fact that, and we have to also come to the realization that 2016 is the date that we have to be concerned about. Whereas we do have responsibilities for our private pension funds and we must continue our work, and I am pleased that we are having this hearing and some of the comment that we are having, but we do not have nearly the responsibility toward them that we do have to save America's largest pension system that does affect every American worker who pays FICA tax, which is just about everybody. That is our responsibility in this Congress. We need to move forward to save Social Security for all time.

Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Washington, Mr. McDermott, wish to inquire?

Mr. MCDERMOTT. Thank you, Mr. Chairman.

As you look at this Committee and answer our questions, you have to remember that there are two committees up here. There are the people from Matsui to Shaw; those are the defined benefit people. And then the rest of us are living in the hybrid world, a little bit of defined benefit and a whole lot of stuff in this defined contribution.

So we have different viewpoints on exactly how this thing works, and I was trying to think, as I listened to you two talk, do you equate asset accumulation with a secure retirement?

Mr. WEINBERGER. I certainly think that asset accumulation should be a component of a secure retirement.

Mr. MCDERMOTT. So the man from Enron, Mr. Presswood, or whatever his name was, who went from a million and a half dollars when he retired to $5,000 when the stock disappeared, you would call that a secure retirement because he had a million and a half when he retired?

Mr. WEINBERGER. I don't know what other assets this gentleman had. I don't know the factual circumstances surrounding this gentleman. I am sorry.

Mr. MCDERMOTT. But certainly if we were just talking about his asset accumulation, he hadn't done a very good job. I mean, he is in deep trouble.

Mr. WEINBERGER. Again, I don't know. You are only talking about one of his investments. I don't know if he had other assets or not.

Mr. MCDERMOTT. Do you think that there should be any guarantee for him when he retired with a million and a half? Or should he still have to keep making decisions—I mean, both of you seem to think that if we give people more choice and more information, they can go out there and this guy will do just fine. But he went from a million and a half to five thousand bucks in a few months. So you don't think the government should guarantee anybody anything? Is that the Administration's position?

Mr. WEINBERGER. I think the government has. I mean, the Social Security system is there to provide a guarantee to all Americans as the safety net. In addition, some employers are certainly able to provide defined benefit plans, which are guarantees. And defined contribution plans or investments that you and I make, you can't—we can't, the government can't outlaw the risk/reward relationship. It is there, and some people are going to be more aggressive and some aren't. Diversification, which is very important to asset accumulation, is something we would like to get the message out more about and try and give people the tools so they can accumulate wealth.

Mr. McDERMOTT. Okay. Let me get to the tools, because I heard you are going to to have a savings summit. I presume there will be some paper that you hand out there.

Would there be anything that you would hand out that would tell people how to read an annual report and spot crooks when they are putting one together and handing it around? Do you have such a paper that would help me—because I am not an economist, and I know a lot of people in my district don't know how to read an annual report. So are you going to give a manual so we can figure these things out?

Ms. COMBS. No, we won't be handing out manuals. There was a SAVER Summit 4 years ago. These are summits that were mandated by Congress in statute, and the first one really focused on trying to educate people about the need to save for retirement. And I think a lot has been accomplished in the last 4 years.

This year's summit is going to focus on people's need to save and how to become better asset managers so that they know what to do in terms of diversification and what messages really target different groups of people. What we are trying to do is break the population down into different generations and to develop the messages and the tools that people need when they are starting out their working career, when they first have an opportunity to decide to sign up for a 401(k) plan, what are the tools and the messages that appeal to people who are mid-career, those who are preparing for retirement, and those who are already retired, so that we can take this effort to the next step and really try to refine how we can educate people about these very important decisions that they have to make and improve financial literacy.

It is a day-and-a-half summit. It is extremely important, and I think it will do a great deal to get the word out. It is only part of our ongoing efforts to improve financial literacy and understanding, but I don't presume to think we can educate people about how to read financial statements in this type of an environment. I don't think that is——

Mr. McDERMOTT. But we put together a law some years ago called ERISA. That was to guarantee that people would have a defined benefit contribution—or they would have a defined benefit pension when they got there. If things went to pieces, the government would give them some guaranteed benefit. I am not sure exactly what the maximum under that was. Can you tell me?

Ms. COMBS. It has been indexed over time. It is now about $43,000 a year.

Mr. McDERMOTT. On top of your Social Security?

Ms. COMBS. Yes, if you have a defined benefit plan. ERISA didn't require you to have a defined benefit plan. It established the rules that they operate under, but it is a voluntary system, and many employers do offer defined benefit plans, particularly larger employers, but there has been real stagnation for a number of reasons, and they are not growing. And to the extent there is growth in the pension system, it is on the defined contribution side.

So those people who are lucky enough to have a defined benefit plan, yes, if they are eligible for the maximum amount that it guarantees, it could be upwards of $43,000, $45,000 a year.

Mr. MCDERMOTT. So they could have $43,000 plus $18,000 of Social Security guaranteed, about $60,000 guaranteed.

Ms. COMBS. Yes.

Mr. MCDERMOTT. And anybody who has a defined contribution program has their Social Security guaranteed, whatever that is, $18,000, and then they are on their own. That is the situation. And it is the Administration's position that we should not do anything about those people, even though they were moving in the direction?

Mr. WEINBERGER. No. It is the Administration's position that we need to do all we can to help to educate those people so they could take part in the capital markets like everyone else.

Ms. COMBS. And defined contribution plans are not unregulated. They, too, are subject to ERISA. There is no insurance program for defined contribution plans. Again, in a defined benefit plan, the employer is promising to pay you a certain benefit when you retire, and there are rules that require them to fund that benefit over time.

The PBGC, the insurance system for defined benefit plans, insures against the company failing. When a company goes into bankruptcy, they turn over their assets to the Pension Benefit Guaranty Corporation as well as their liabilities. So a lot of that guarantee is paid out of money that has been accumulated by the employer and is transferred over to the Pension Benefit Guaranty Corporation.

Defined contribution is a very different animal. There the employer is only saying what he or she is going to contribute each year, and the ultimate retirement income does depend on investment gains and losses that you experience. We are trying to help people make good choices, to diversify their accounts, to get advice, and to be prudent with respect to their management. So we are trying to reduce the risk in defined contribution plans without an insurance system.

Chairman THOMAS. The gentleman's time has expired. I would tell the gentleman we will go into the defined benefits at a hearing, and one of the questions we will want to pursue is why the defined benefit declined so rapidly, which provided for the defined contribution to build up. I think you might find one of the reasons was we put so many burdens on the defined benefit to make it "fairer and safer," that employers shifted and employees shifted to the defined contribution. We may be successful in ruining that one as well.

Does the gentleman from Texas, Mr. Johnson, wish to inquire?

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Secretary Combs, you made a statement during your opening remarks about the responsibility, the fiduciary responsibility of an employer during a blackout period. That wasn't part of your written statement. Can you elaborate on that?

Ms. COMBS. Yes. Under ERISA, employers have a fiduciary responsibility to manage the plans prudently and solely in the interest of the workers in those plans.

Now, there is an exception for individual account plans like a 401(k) plan where the control over the investment decisions is transferred to the individual worker.

The Department of Labor issued regulations in 1992 defining what "control" was. If you don't shift control, the employer is responsible for the investments in the plan. If you are under what is called section 404(c) and you shift control to the worker, the employer is no longer responsible for the results of the investment decisions that worker makes. And that is what 404(c) does. It shields them from the results of the participant's investment decisions.

What we are proposing is that during a blackout period, by definition, employees don't have control over their accounts; and, therefore, the employer, if they breach their fiduciary duty, would be responsible for losses that workers suffered that result from that breach. So it——

Mr. JOHNSON OF TEXAS. They can't control the market.

Ms. COMBS. Lawsuit, essentially—I am sorry?

Mr. JOHNSON OF TEXAS. They can't control the market. How can they be responsible for a loss?

Ms. COMBS. We are not saying that they are responsible for any losses attributable to market changes. If the loss can be—if the plaintiff can prove in a lawsuit that they suffered a loss because of the fiduciary breach that the employer engaged in, then in that limited circumstance the employer would have to make that person whole. So they have to prove the breach, and they have to prove that the loss was due to the breach.

Mr. JOHNSON OF TEXAS. So that is the remedy under current fiduciary law, and do you think the participants have adequate access to remedies of the fiduciary irresponsibility?

Ms. COMBS. I think the remedies under ERISA for pension plans are very vigorous. The plan sponsor, the fiduciary, is personally liable for losses to the plan, to make the plan whole plus interest. There are criminal provisions under ERISA for things such as embezzlement, money laundering, fraud.

We have an active enforcement program, and I think you will find that the remedies and the fiduciary protections for the pension side of the equation are quite——

Mr. JOHNSON OF TEXAS. I know you are in an investigation into Enron. Can you generally explain a typical time line for prosecution of fiduciary breaches? Are we talking about years or months or what?

Ms. COMBS. It really does depend on the complexity of the situation. We can bring some cases that are very cut-and-dried and can proceed rather quickly.

We have an active program, for instance, in making sure that 401(k) contributions that are withheld from people's salary are contributed to the plan in a timely fashion. Those are pretty cut-and-dried, quick cases.

Mr. JOHNSON OF TEXAS. But in this particular instance, where are we?

Ms. COMBS. This is a very complicated case, and we are working on it as quickly as we can. We are devoting all the resources that we need to it. But I wouldn't—I can't presume to tell you when it will be finished, but I think it will be rather lengthy. It is obviously a very complicated situation.

Mr. JOHNSON OF TEXAS. When you say that, are you talking about a year?

Ms. COMBS. You know, I hesitate to put a timeframe on it. I don't want to—we will do it as quickly as we can.

Mr. JOHNSON OF TEXAS. Okay. Pension plans are audited annually, are they not?

Ms. COMBS. Yes, they are.

Mr. JOHNSON OF TEXAS. Those audits get filed in a 5500 with you, I believe. Do you think that the fiduciaries and the Department of Labor officials who receive that form ought to look at those audits and follow up on recommendations made in them?

Ms. COMBS. We do review the auditor's report. There is an exception for small plans with fewer than 100 participants to file an audited employee benefit plan. But we have an Office of the Chief Accountant within the Department of Labor, within my agency, that does review the accountant's work product to make sure that we have clean opinions, and audits those audits, if you will.

Mr. JOHNSON OF TEXAS. Okay. Secretary Weinberger, the Treasury has announced it won't issue 30-year bonds anymore and eliminating that rate is going to cause some of the companies to face tens of millions of dollars of pension contributions because of the funding formula.

The House passed a temporary solution back in November, and we have written letters, along with Portman, Cardin, and Pomeroy, to Secretary O'Neill and haven't had a response.

Do you think that you are going to support the House-passed version, or do you support some other approach?

Mr. WEINBERGER. Well, first of all, we did support, as you know, Congressman, the provision in the simplification bill which would have dealt with it on a short-term basis. And, yes, we do support revisiting that and working with you to try to determine what the appropriate rate should be.

Mr. JOHNSON OF TEXAS. Okay. Thank you very much, Mr. Chairman.

Chairman THOMAS. Does the gentlewoman from Washington wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman.

Welcome to both of you. I think, Secretary Combs, knowing what a huge percentage of the Labor Department your office, the office that you manage, controls, I think it is wonderful to have you here talking to us about what we are dealing with.

A couple of questions. Let me move back to the employer liability issue that Mr. Johnson approached. I have seen a number of bills that treat this issue constructively, but I think we have to be very careful about going too far here, particularly, for example, during a blackout. And my concern is that that sort of thing could make companies, in essence, legally liable for fluctuations in the market. So I am interested in hearing more from you about that. Do we believe that litigation is the best way to handle the retirement system to provide regulation to it? And my further concern is: Would this be a disincentive to employers to offer 401(k) programs?

Ms. COMBS. We don't believe that this will be a disincentive for employers to offer 401(k) plans. Let me be clear. We view this as a clarification of current law. Several of the lawsuits that are pending by private litigants in situations, Enron and other situations, are based on this theory, that the control—that the individual workers did not have control and, therefore, fiduciaries may be liable for losses if they breached their fiduciary duty and that caused the loss. So it is important to understand that we view this as a clarification. In that way, I think we can help by making it very certain that what we are not saying is that you are a guarantor of investment downturns in the markets during a blackout period.

But what we are trying to do is get the incentives right. Several of the proposals in the President's plan, both this proposal on liability and the parity proposal, with freezing executives' ability to sell stock, are designed to make sure that those blackout periods are administered fairly, that they are as brief as possible, and that they are done because they are in the interests of the workers in the plan.

It is a fiduciary responsibility under current law. The decision to impose a blackout period and how you administer it is a fiduciary decision under current law. We want to make sure that people understand that and take that seriously. I think that would prevent a lot of the anxiety that people have suffered in recent circumstances.

Ms. DUNN. Great. Thanks.

One other question. I think you would have to agree that participation by normal people in 401(k)s has been a huge addition to the responsible planning of one's retirement, and I don't know what the numbers are. You might have already stated them. I know they are something over 50 percent, close to 50 percent of folks who are invested, for example, in the stock market. Every time we talk about reducing capital gains taxes, we talk about this huge number of people who already take part in managing their own retirement.

This whole movement has created amazing wealth and savings opportunities for ordinary Americans like those of us who are sitting in this room. On the other hand, there is a great deal of misunderstanding about the responsibilities that come with this sort of investment risk and how important diversification is.

Do you think there is a role for the government in providing education to people about the risks?

Ms. COMBS. One of the proposals in the President's plan is to require employers to provide quarterly benefit statements in 401(k) plans and to include in those statements a description of the advantages of a diversified portfolio and basic investment principles to try to improve financial literacy and people's understanding of the risks and rewards here.

So, yes, I think we can encourage employers to make this information available. I think, again, many employers do want to have an educated work force in this area. It is in their interest in having, you know, a content and stable workforce to make sure that they understand how to invest their 401(k) plans. So I am optimistic that we are going to get more information out there.

Ms. DUNN. Good. Thank so much. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you. Does the gentleman from Georgia, Mr. Lewis, wish to inquire?

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman.

Mr. Chairman, before I ask my question, I am sort of curious about what my colleague from Washington meant when she said something about normal people who participate in 401(k)s. I didn't quite understand that. Something about abnormal people who participate? I just didn't understand it. I wish she would——

Ms. DUNN. I think we are talking about a group that is not necessarily the management of a company, for one thing.

Mr. LEWIS OF GEORGIA. Well, thank you for informing me. I appreciate that very much.

Secretary Combs, you said a great deal in your statement, but I really want to know what can we do, what can this Administration do to reassure the workers, the employees that their pension, their 401(k), their nest egg will be safe, secured, and protected?

Ms. COMBS. Well, I think there is a two-pronged approach. I think the President has come forward very quickly in response to legitimate concerns that have been raised by the public with a very vigorous package that will strengthen the protections of workers in 401(k) plans.

At the same time, we are in the midst of conducting an investigation into the Enron situation. I can't talk about the details. I appreciate your understanding in that. But, also, we have a tough enforcement program, which I think will demonstrate to the public that we take our responsibilities in that area seriously. There are serious sanctions if we find that there have been violations. And we are prepared to move on that.

So I think the combination of tough enforcement and a responsible, vigorous legislative package will do a great deal to restore people's confidence.

Mr. LEWIS OF GEORGIA. Thank you.

Secretary Weinberger, do you believe that the Federal Government, that our government should bail out employees who lose their pension, their nest egg? Do you think that is a role for the Federal Government to play? I think this is really a follow-up to what Mr. Rangel was asking.

In the past—you know, we have a rich history in this country of bailing out things: the S&Ls, railroads, the automobile industry, a few months ago the airlines. What about the people who lose their pensions?

Mr. WEINBERGER. Mr. Lewis, as my colleague, Ms. Combs, was talking about earlier, for defined benefit plans the Pension Benefit Guaranty Corporation is there as a company goes bankrupt to be a reinsurer of those plan assets. So that is something we already do do. Of course, we also provide Social Security benefits, so there are several things we do.

With regard to the defined contribution plans, the best thing that the government can do there is to try and aid individuals to better understand their opportunities for diversification, the opportunities to create wealth, and to put appropriate protections in so that they are not taken advantage of. And that is all part of the President's plan.

Mr. LEWIS OF GEORGIA. Do you or anyone in the Administration, do you have any plans to come to the rescue of the Enron employees?

Mr. WEINBERGER. I am not involved in any way in the Enron investigation or know anything about the details of that case.

Ms. COMBS. We do have an ongoing investigation into the Enron situation. We normally don't talk about our investigations. This was a situation that was quite extraordinary, so we did——

Mr. LEWIS OF GEORGIA. Let me come from another angle. Do you think, do you believe that the Federal Government should play a role, whatever comes out of the investigation, in helping secure what these people lost?

Ms. COMBS. We are going to pursue—if we find that there was wrongdoing in the Enron situation, we will pursue that, and we will bring to bear the full panoply of sanctions that are available to us under the law.

Mr. LEWIS OF GEORGIA. Thank you, Madam Secretary. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Georgia, Mr. Collins, wish to inquire?

Mr. COLLINS. Thank you, Mr. Chairman. And I won't attempt to address "normal" or "abnormal."

You know, I am amazed as I listen to Members talk about guarantees. You know, there are only two things I know that we are guaranteed as individuals is death and taxes. This Committee has a lot to do with taxes, but only the Good Lord has to do with death.

We have a tendency to try to immediately come up with a lot of solutions and a lot of answers when something like the Enron situation pops up at us, and it is a major, major situation for a lot of people who had their monies invested in their stock and in their plans.

But if we just step back and look and observe people, we will find that people are a lot smarter than we give them credit for. I think with the Enron situation a lot of people have become more involved, more interested, and are looking and learning and watching closely as to what is happening with their investments. They are concerned about the Dow average, the Nasdaq average. They get excited when they see it going back up because they know their retirement funds are being restored somewhat.

We have a tendency here to hold hearings going out our ears. Today we are on the defined contribution. Later we will do the defined benefit. But I think the most important hearings or investigations that are going on in this town are by the Justice Department and other agencies. And as I hear people in the 3rd District of Georgia refer to this subject, they immediately say if there have been any violations of law, then those people should be prosecuted and punished accordingly.

In fact, some even say we have a nice little building down there on the boulevard in Atlanta called the U.S. Penitentiary that could house them rather than some golf-course resort in some other areas of the country.

But those types of corrective measures, once the evidence shows and the prosecution goes through and people are paying the debt for wrongdoing, those types of corrective measures will have a resounding effect on others who would commit the same type of fraud and deceit.

I hope that the President's Task Force takes time to fully review everything about this situation and possible others. I have said before to this Committee, my daddy was the smartest man I ever knew, even though he had less than a third-grade education. But he used to tell me, he would say, "Son, haste makes waste."

Don't get in a hurry. Take your time. Thoroughly review everything that has gone on with the people who have committed these acts of, I think, deceit and fraud against good people. Don't take a knee-jerk reaction. And I believe the people of this country will come out a lot better than we sitting up here holding political hearings instead of doing really good work. And the recommendations that I see that you put forth here for this defined contribution that the President has put forth I think make good sense. They are not a knee jerk. They are not going beyond the realm of what should be happening. And so, therefore, I appreciate each of you being here.

Chairman THOMAS. Does the gentleman from Pennsylvania, Mr. English, wish to inquire?

Mr. ENGLISH. Thank you, Mr. Chairman.

I would like to thank the witnesses for coming before us today and offering on behalf of the Administration a set of proposals that I think build on the extraordinary success of the 401(k) provision over the years, which I believe, whatever the recent problems with any particular company, we certainly want to preserve.

I also want to congratulate the Administration for laying before us a set of positive proposals that are clearly pro-employee and are clearly populist in their thrust. What you have done is lay out a set of proposals that would make it easier for employees to control and protect their own pensions.

And I also am glad, Ms. Combs, for your testimony clarifying the fiduciary responsibility under this proposal of employers.

I am wondering, normally with pension funds—and I think I know the answer to this, having been the trustee of a municipal pension system. Normally, do fiduciary standards require diversification?

Ms. COMBS. Diversification is one of the fiduciary standards. There are exceptions in ERISA for individual account plans such as 401(k) plans.

Mr. ENGLISH. Okay. Normally, are private fiduciaries required to maintain diversified plans or portfolios on behalf of those they are acting for?

Ms. COMBS. Outside of the employee benefit plan context?

Mr. ENGLISH. Yes.

Ms. COMBS. I am not sure I know the answer to that. Under common law of trust, yes.

Mr. ENGLISH. Okay. Your proposal, as I understand it, allows employees the ability to diversify their portfolios at will, much more quickly than the current law does, and does not require that diversification. Is that a fair assessment of your proposal?

Ms. COMBS. That is correct. It just gives the people the right to choose to divest if they want to, if they so choose.

Mr. ENGLISH. As you may know—and, Mr. Weinberger, I know this didn't make your testimony's seemingly exhaustive list of contributions by Members of the Committee, but I have introduced a bill, the Safeguarding America's Retirement Act (SARA) House bill 3677, that speaks to some of these concerns and I think differs with the Administration's proposal in one particular that I would like to focus on for a second, and that is, I would require, as some other proposals do, that no more than 20 percent generally of a portfolio under a 401(k) be invested in a single asset.

I think you have already addressed this, Mr. Weinberger, in your exchange with the Chairman, but I would like to draw you out. As I understand it, your position is that this is unnecessary and potentially arbitrary to be setting a specific limit.

Ms. COMBS. Well, there are a number of reasons that we did not go down this road. We have, as you correctly identified, Mr. English, emphasized choice, investor choice, and giving them the opportunity for diversification as opposed to government coming in with a specific mandate.

There are other issues that it raises, particularly with regard to how it would be administered, such as we talked about, for example, as assets accumulate, how would the cap apply? There is potential—and I can explore this further with you, but there is potential complexity because you have to go to look at each individual account to see whether each individual account had more than a specific percentage in it, and then let that individual diversify, as opposed to a defined benefit-type approach where it is a universal and single plan. So there are lots of issues that are associated with it.

Mr. ENGLISH. I would like to get your analysis of that administrative complexity problem, because it is an issue that we are aware of. I think it is a soluable problem. But I think you have raised a legitimate issue.

You also said that 401(k)s are designed to be only one component of an individual's retirement, and that on that basis I understand you would not think that a—you would not argue that a 20 percent standard be enshrined in law. Is that fair?

Mr. WEINBERGER. Mr. English, what I was saying was that a 20 percent standard may be appropriate for some but not for others. If it is their only asset, who would know what it would be? It is hard to say, to come up with a bright-line, arbitrary test to apply to all plans and all individuals.

Mr. ENGLISH. And that is what we have tried to do in my bill, and what I would like to do, knowing, Mr. Chairman, that our time is limited here, I would like for an opportunity to explore in greater detail with the Administration some of their concerns on this particular issue and perhaps see if we can find a way to resolve them. And I thank you very much.

Mr. WEINBERGER. We are happy to do it, and I will amend my testimony, Mr. English, to include your——

Mr. ENGLISH. Not necessary.

Chairman THOMAS. I thank the gentleman from Pennsylvania, Mr. English, capital E–N–G . . .

[Laughter.]

Chairman THOMAS. Does the gentleman from California, Mr. Becerra, wish to inquire?

Mr. BECERRA. Thank you, Mr. Chairman.

Thank you both for taking the time to come, especially on a Monday. Let me first ask Mr. Weinberger a question. You mentioned—and, actually, Secretary Combs, you as well also mentioned it—the issue of education. And as best I can understand from what you said and the proposal that we have seen so far from the President, it is to provide additional information about what has gone on, the activity that has occurred with regard to various investment options that an employee can receive through the employer.

Other than these quarterly contribution statements, is there anything else that you mean or refer to when it comes to the issue of educating employees when it comes to some of these risky investments?

Mr. WEINBERGER. In the President's proposal, in the quarterly statements there would be a requirement that there be discussions of the benefits of diversification. So there would be a part there.

In addition, I am not, I must admit, involved in it, but in Treasury there is a separate program ongoing, which is a financial literacy program that is run out of the Department, the Domestic Finance Division, that has a goal to try and increase financial literacy for everyone, employer and those unrelated to work.

Ms. COMBS. The President's proposal also incorporates legislation that was passed by the House last year, the Retirement Security Advice Act, to give people access to individualized investment advice with respect to their plans as well.

Mr. BECERRA. With regard to Enron employees, what level of advice would have made their investments secure through Enron?

Mr. WEINBERGER. Well, certainly, you know, obviously—again, I don't know the facts of Enron, but the more individuals hear about the benefits of diversification, understand risks, understand rewards, we would hope to have a more educated consumer, and that would be helpful. Individuals could make different choices.

Mr. BECERRA. But if you are referring to their quarterly contribution statements and the information they could have received with regard to investments, those statements would have reflected what Arthur Andersen and other companies, investment companies were saying about Enron that in some cases it might have still been a good purchase even when we knew that it was close to collapse. So I am not sure if just providing education, as the President proposes, is going to do much to help a lot of employees, as we saw with Enron.

But with regard to that advice legislation that this House passed out, that I understand the President supported, and my understanding is you have adopted in the President's plan, the President himself adopts, again, in now his plan to provide some reform of our pension system, we have the whole issue of conflict of interest, of a pension fund manager providing advice.

Let me make sure about something. Enron had an interest in seeing its employees invest in its stock. Enron had an interest in seeing its employees be encouraged to invest in its stock. And certainly when most Enron executives had an idea that the company was nearing collapse, those Enron executives and Enron as a company had an interest in seeing those employees maintain their funds, their pension funds, in that Enron stock. In fact, there is evidence that they were encouraging, these executives were encouraging Enron employees to continue to invest in Enron when they themselves were pulling their moneys out of their 401(k)s with Enron and were, in fact, aware that the company was nearing collapse.

If those are the interests of Enron and Enron was giving this type of advice, imparting this advice to its employees, does the Administration still wish to take the posture that it would want to encourage fund managers, very much like what Enron executives were doing, to give advice to its employees on how to invest their money, despite the fact that we know there is a self-interest or a conflict of interest that could easily be involved?

Ms. COMBS. What the President's proposal on the bill that was adopted by the House would do is make it easier for all employers to hire someone else to give the advice. And what the bill does is allow them to hire an investment manager——

Mr. BECERRA. But it could also hire people——

Ms. COMBS. For instance—I am sorry?

Mr. BECERRA. It could also—Enron under this proposed law that the President supports could also hire a fund manager that it is paying to give advice on with whom to invest, which could include Enron itself.

Ms. COMBS. Which could—no. It has to be a regulated financial institution. You have to hire——

Mr. BECERRA. But that institution, if Enron has contracted with that financial institution to do accounting and, therefore, has an interest that that firm, that accounting firm, do well and that accounting firm has an interest in seeing Enron do well since it has a contract with it to do accounting work and other investment work, wouldn't there be a conflict in allowing that accounting or investment company to then turn around and tell employees that it should invest in Enron stock, without having to necessarily give full disclosure about its relationship completely with Enron?

Ms. COMBS. There are protections in the bill, and what it would do, you would have to be either a regulated bank, broker-dealer, insurance company—I am forgetting the—mutual fund complex——

Mr. BECERRA. But how does that stop an employee——

Ms. COMBS. You have to be someone who is a professional investment adviser.

Mr. BECERRA. But how does that stop an employee from ultimately receiving advice which is conflicted or has a self-interest, which is permitted by the legislation——

Ms. COMBS. The adviser is a fiduciary. They have personal responsibility for the advice they give. They must disclose the conflict. They must disclose their fees. They must disclose the relationship.

Mr. BECERRA. But, Secretary Combs, is it not a fact that the advice ultimately could be conflicting advice and it could be self-interested advice?

Ms. COMBS. That would be illegal under the bill. If they did that, they would be violating their fiduciary responsibility, and it would be illegal.

Mr. WEINBERGER. You have to run it solely for the benefit of the employees, which is a fiduciary standard, and it will require a legal analysis.

Mr. BECERRA. Okay. Well, I thank the Chairman for the time, and I would like to explore that later on.

Chairman THOMAS. They could go ahead and do it, but they would be responsible.

Mr. BECERRA. So they could do it——

Chairman THOMAS. For their behavior, i.e., they would be——

Mr. BECERRA. As we saw the executives in the Enron case.

Chairman THOMAS. Breaking the law.

Mr. BECERRA. We saw a lot of folks breaking the law and a lot of folks——

Chairman THOMAS. I understand that, and there is an investigation to look at that.

The other points, perhaps the gentleman was not here when the other Administration points were presented in terms of changing the blackout rules, and probably one of the better ideas I have heard is, as it was articulated, what is good for the top floor is good for the shop floor. If the management, notwithstanding the fact they are not in a 401(k) plan and they have stock and they make decisions about the stock, that has to be disclosed so that the shop floor can follow the top floor on flight away from the company's stock, as may have been the case in Enron.

Again, the fundamental rule here of transparency I think goes a long way toward resolving some of the particular problems, but we have a panel following this one that might want to either support or augment some of the President's proposals, and we look forward to hearing from them sometime today. If not, we will hear from them Tuesday.

Does the gentleman from Louisiana wish to inquire?

Mr. McCrery. Mr. Chairman, just briefly.

I am sorry I was not here for your testimony. I was with the President announcing his welfare reform proposal, which is very good. But I did have a chance to read some excerpts from your testimony, your prepared testimony, and I want to compliment you on the tone of your testimony and the kind of thorough, go-slow approach that I believe we should take in this matter.

Frankly, the way I see it, most of the fine-tuning that needs to be done with respect to pensions and 401(k)s, defined contribution, defined benefit plans, like outside the jurisdiction of this Committee. And there are other committees, Financial Institutions, Commerce, looking at doing some things with respect to stock manipulation, stock value manipulation, those kinds of things that were going on with Enron, or least appeared to be going on with Enron, that need to be corrected. And those ought to be done.

But as you pointed out in your testimony, the pension system, the defined contribution system, has worked extremely well in this country, providing much more financial security for many, many more people in this country than ever before, and we ought to be very, very careful before we tamper with something that has worked so well.

So that is really all I wanted to say, Mr. Chairman. I appreciate the tone of their testimony and look forward to working with the

Administration to fine-tune, perhaps, our system but be very careful not to do anything that would harm it more than it would do it any good. Thank you.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Oklahoma, Mr. Watkins, wish to inquire?

Mr. WATKINS. Thank you, Mr. Chairman.

Let me say, I think you have got some good points to be made in the legislation. I think it is a step in the right direction, trying to root out some of the things that can bring around some fraud and criminal action. I think we have got to try to address that. If there have been some wrongdoings, then we need to find out. But you cannot get the entire—we have free enterprise, capitalism and all. We are not going to be able to take all risk out of everything. We are going to have freedom in investment and freedom doing business. We are going to have to have the opportunity to have the responsibility of succeeding and failing. But we need to make sure we try to root out all the—but that is going to be tough to always do. They always find different ways, you know.

Let me just ask for a reflection, Mr. Chairman, if I might. Who is the person that today is looked at as probably the greatest responsible person about the economy? Most people would say probably Greenspan. That is probably true in most people's minds.

But if you look around at some of the people that have lost by far more money, it has been in CDs or certificates of deposits at banks, lost more money in the interest rates, the CDs. You ask any elderly person who has been trying to live on interest rates, back when they had—not too many months ago down the road they had 6, 7, 8 percent from some CDs or the treasury securities. There has been a greater percentage of loss from the CDs at the banks and the treasuries than the stock market overall. Now, there are isolated companies that have had a higher percentage, but overall. So when you look at that, I would say we have got to be careful on what we propose and what we require, when we take away a lot of the freedom of investors across this country.

I can assure you there is an outcry of a lot of the elderly about the interest rates, but were those decisions made in the best interests of the country, of trying to make sure we stimulate the economy, I am quite sure, and most of our elderly people say do whatever is necessary to move this country forward. And I think that is what we have got to look at as we try to protect investors as much as we can, give them the guidelines, give them the education, root out those who criminalized the system, and I think we can solve some of the problems.

So I want to thank you for bringing this. I will be looking at it very carefully as we go through here, but I think we have too many people who want to throw everything out with the—the baby with the bath water, so to speak.

Thank you, Mr. Chairman. I just wanted to make that point.

Chairman THOMAS. I thank the gentleman. Does the gentlewoman from Florida, Mrs. Thurman, wish to inquire?

Mrs. THURMAN. Thank you, Mr. Chairman.

I will be like everybody else. Thanks for being here, although I was a little concerned that I wasn't mentioned in your testimony, Mr. Weinberger. So I will ask you what Mr. Ramstad would be asking you if he were here today, which is about ESOPs. We worked on this just for your next testimony before the Committee so you can——

[Laughter.]

Mrs. THURMAN. I actually had the opportunity, oh, I would say a couple weeks ago, to go down to actually talk to a group of ESOP owners in the Southeastern part of the United States. It was a small group. And I have to tell you, they are very, very concerned about what is going on up here and certainly what kind of an effect this will have on their ESOPs.

This was not the owners. In fact, these were the employees of the ESOPs that are asking us, and Mr. Collins' Southern way of saying, slow down, you know, don't throw everything out.

And I notice that you did in your testimony spend some time on ESOPs, and I guess maybe we can do this at some other time, but we do know already in the ESOPs that they already have diversification that they have to meet. And it is pretty well spelled out. I mean, I am not sure in other areas in pension plans that they have been as—they are as good as what can happen in these other—in ESOPs.

And you did say stand-alone ones would be okay. I guess you are not going to worry about them.

So who are those other companies that you see out there that are not stand-alones that might be affected by this, that are going to have some concerns because they may be small, you know, 20, 30, 40 employees that may end up having to meet some of those diversification requirements that are not going to be able to? I mean, are we going to open up a can of worms here for some of these other ESOPs, and how can we work through this?

Mr. WEINBERGER. Congresswoman Thurman, it is a really good question, and we do embrace the spirit behind ESOPs, which is to provide ownership and certainly to transfer to employees ownership, which is a positive thing, an alignment of employees and owners. That is why we did carve out stand-alone ESOPs. That is really how you leverage a company, with the stock in the ESOP, and you go ahead and you basically are able to transfer that ownership, and that is a positive thing.

What we have seen, what has happened is ESOPs, because there are special tax advantages unique to ESOPs, have become part and parcel in many cases of 401(k)s, and there are matching contributions for ESOPs. If we were not able to treat those ESOPs where you have matching contributions or where they are part of 401(k) with the same 3-year diversification requirement as we do for 401(k)s, it would be a way to get around the entire diversification rule because everyone could then elect to be an ESOP.

Mrs. THURMAN. Knowing that we just got this testimony, and certainly with the issue that you have laid out fairly well in your testimony before us, let's not close the door yet. I need to have some—we need to sit down and really kind of talk about this and see what these special cases are, because I think they are one area that, in fact, did do some diversification before, you know, they were asked or were told to do something and pretty explicit in what they can do.

If the issue is on tax law, then we will talk about the tax law, but I don't know that it necessarily has to do with the diversification part of it. So I just leave this open-ended and hope that we will have some more conversations about this issue.

Mr. WEINBERGER. Happy to do it.

Mrs. THURMAN. Thank you.

Chairman THOMAS. I thank the gentlewoman. Does the gentleman from Illinois, Mr. Weller, wish to inquire?

Mr. WELLER. Thank you, Mr. Chairman.

Mr. Weinberger, Ms. Combs, thank you for spending a lengthy afternoon with us on an important issue. Of course, we are talking about retirement security today, something that is important for all of us. Forty-three million Americans today have 401(k)s, and in the almost generation-long experiment of 401(k)s, they have been pretty successful in giving people an opportunity to have an opportunity to save for their retirement, particularly for small employers now with the changes that we have made in the last few years.

I find that employees and workers tell me they like the choices, they like the control, they like the fact that a 401(k) is portable if they change jobs or positions.

But, of course, what has occurred in the last few months has drawn a lot of attention to how these plans are potentially managed and some of the questions that occur. So I think this is a very helpful hearing, I know certainly for me.

I would just like to get a clarification on a couple questions. This past fall, of course, we passed the Retirement Security Advice Act, legislation that you have addressed in your legislation that the President has now put forward. And we passed it last fall, and like most legislation the House passes, the Senate hasn't done anything on this issue. And hopefully they will one of these days, but the bill that we passed last fall, you said you used a base bill. Is your proposal identical to what we passed out of the House last fall, or are there some changes or differences in what is in the President's bill?

Ms. COMBS. It is the bill that was passed out of the House.

Mr. WELLER. And have you added anything to it, any additions? So it is identical to the proposal?

Ms. COMBS. No. We thought that it would make sense, since this was something that had broad bipartisan support in the House and that we had endorsed previously, that we would just incorporate it by reference into our plan.

Mr. WELLER. Could you give an example of how an average worker would—you know, if the Retirement Security Advice Act was signed into law as the President has endorsed, how would a worker, an average worker in the south suburbs of Chicago, Illinois, be able to take advantage of this? What would it mean for them, the choices they would have to make and be able to make an informed choice?

Ms. COMBS. There are two components to the bill. The first would clarify that employers who wanted to make investment advice available to their workers would not be responsible for the actual advice given. That fiduciary responsibility would shift to the adviser. So that we think would create a real incentive for employers to make this service available. That has been a chill in the market, if you will.

The second piece is to say that financial institutions, regulated financial institutions who have a relationship to the retirement plan would be allowed to give individualized advice to workers in the plan, provided that they acknowledged that they were a fiduciary when they were doing that so that they had to act solely in the interest of the worker, not in their own corporate interest, that they assumed fiduciary liability, and that they disclosed their relationships, they disclosed their fees, any limitations on their advice, that there was very full and fair disclosure.

Say a small- or medium-size employer that offered a 401(k) plan, they want to go to one service provider. They call it bundled services. They want to contract with Fidelity or Vanguard or Merrill Lynch or an insurance company as the principal. They want them to provide all the services. They would be able—the Fidelitys, the Vanguards would be able to sit down one on one with workers and talk to them about their investment choices that they were making in their 401(k), and then the worker would choose whether or not to follow that advice.

Mr. WELLER. And would there be any additional cost to the worker to obtain this investment advice from these service providers?

Ms. COMBS. The way the bill is structured, the employer could choose. They could choose to pay for the advice. They could pass the cost on to workers who elected to receive it. They could spread it out over the plan as a whole. There would be flexibility there.

Again, we think it would be a lower cost if it were provided by the service provider who otherwise had the relationship to the plan because they would tend to have economies of scale. They already know the plan. They know the plan design. They could offer it for a lower price.

Mr. WELLER. Now, there has been a bipartisan effort in this Committee over the last several years, led by Chairman Thomas and our colleagues Mr. Portman and Mr. Cardin, to simplify our opportunities for retirement savings and security, and we, of course, passed a major portion of those changes this past year in legislation that the President signed last June, something that was commonly known as Portman-Cardin, and gave an opportunity for greater retirement savings.

With the President's proposal, what kind of changes would the President recommend that we make to the legislation that was passed earlier this year? Does he see any need to modify that legislation based upon the recommendations he has made?

Mr. WEINBERGER. Congressman Weller, no. We at Treasury and the Internal Revenue Service (IRS) are trying to do everything we can to write regulations to implement the good things that were in that legislation, to expand the ability of individuals to participate. This plan is aimed at just adding further protections to the individuals through the diversification and the investment advice and other issues we talked about.

Mr. WELLER. Thank you, Mr. Chairman. I see my time has expired.

Chairman THOMAS. Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman.

Mr. Weinberger, yesterday's Wall Street Journal reported that your firm lobbied for the Swap Funds Coalition. The article identified the coalition as, I quote, "a group of financial firms that ran exchange or swap funds and opposed changes in how the funds are regulated."

Who were the specific members of the coalition?

Mr. WEINBERGER. I have no recollection. That had to be 5 years ago. It was on my disclosure form. It had to be at least—I haven't lobbied on issues for many years, but it had to be since 1999 or 2000, or 1998. So I don't know the answer to that.

Mr. DOGGETT. The same article said that your spokeswoman said that your firm was paid in 1999 for that fund. You don't know who any of the members of that coalition were?

Mr. WEINBERGER. I don't recall, Mr. Doggett.

Mr. DOGGETT. Is that information that you can get for me?

Mr. WEINBERGER. I don't know. You can certainly call the old firm and ask them.

Mr. DOGGETT. Well, in the July 2, 1999, Washington Post, you were quoted as a lobbyist representing another coalition, a coalition of businesses, which you said found attempts by the Treasury to establish strict standards to define tax shelters as "an anathema." Do you recall whether Enron or any of its subsidiaries, partnerships, or joint ventures were a member of that coalition or any of the other coalitions for which you or your law firm lobbied?

Mr. WEINBERGER. I don't recall, but I don't believe they were.

Mr. DOGGETT. But you do not have accessible to you a list of the members of the coalitions for which you lobbied on any matter within the jurisdiction of the Treasury Department during 1999 or 2000, just before coming to this job?

Mr. WEINBERGER. I am not aware—no, I do not have any list of individual member companies or was not required to produce one. it is not part of any ethical requirements, and I have not done so.

Mr. DOGGETT. Would you be willing to provide such a list?

Mr. WEINBERGER. I don't have—I don't have such a list.

Mr. DOGGETT. And you don't have a recollection as to who any of the individual companies were that were members of those coalitions?

Mr. WEINBERGER. Again, you can check with the company that I worked for, but I don't know the relevance to the issue we have today before us in the 401(k) area or any other issues that I am working on with the Treasury Department.

Mr. DOGGETT. Regarding the testimony from Ms. Combs on the Retirement Security Task Force appointed by President Bush on January 10th, composed of the Secretaries of Treasury, Labor, and Commerce, or their designees, to consider pension concerns arising from the Enron debacle, is that a Task Force in which both of you have participated?

Mr. WEINBERGER. On the Retirement Security Task Force?

Mr. DOGGETT. Yes.

Mr. WEINBERGER. Yes.

Mr. DOGGETT. And you also, Ms. Combs?

Ms. COMBS. Yes, I helped staff Secretary Chao.

Mr. DOGGETT. Can you identify all of the individuals, organizations, and corporations that to your knowledge had met with Members of the Task Force on a matter within the scope of its review?

Ms. COMBS. The Task Force itself during its deliberations from January 10th until today has not met with outside organizations. It really has been a matter of internal deliberations among the agencies.

Mr. DOGGETT. Has it received to your knowledge any communications, electronic or written, from any nongovernmental source?

Ms. COMBS. Not to my knowledge as a task force. I am sure the Members of the Task Force have received information and feedback from many people who would be affected by these proposals, but not the Task Force itself.

Mr. WEINBERGER. Well, I think the Employee Benefits Research Institute (EBRI)—I do recall getting some information from them with regard to what type of plans are out there. EBRI.

Ms. COMBS. That is correct.

Mr. DOGGETT. I know that the Secretaries with whom you work have many responsibilities. Is the most immediate day-to-day work of that Task Force done by you as designees from your respective Secretaries?

Mr. WEINBERGER. No. The most immediate day-to-day work is done by the people behind me, and also the Domestic Finance as well, which is Assistant Secretary for Financial Institutions, Sheila Bair.

Mr. DOGGETT. But the Members of the Task Force were not given the responsibility of seeking opinion from any nongovernmental source for any of their work?

Mr. WEINBERGER. That is correct.

Mr. DOGGETT. There has been a recommendation that following the announcement by Cindy Olson, an Enron Vice President, at a 1999 meeting with Enron, that its employees should keep 100 percent of their 401(k) in Enron stock, that within about 3 months she sold a million dollars of Enron stock. I am wondering if you support individually a requirement that company executives that engage in such inside stock sales promptly notify the pension plan administrator that they have done so.

Ms. COMBS. I would certainly take it under advisement. I would want to think about it. But it strikes me as something we could consider.

Mr. DOGGETT. You don't have an opinion on it?

Mr. WEINBERGER. No.

Mr. DOGGETT. Okay. And, similarly, both the Wall Street Journal and the New York Times have reported that an obscure provision in legislation that this Committee approved last year actually provided an incentive to encourage—a tax incentive or tax subsidy to encourage corporations to contribute company stock to 401(k)s through K–SOPs. Given the large percentage of company stock in plans for Procter & Gamble, Enron, a number of other corporations, do you support continuing a tax subsidy to encourage the placement of company stock in 401(k)s?

Mr. WEINBERGER. I just had this dialog with your colleague, Mrs. Thurman, about the Administration is supportive of ESOPs. We do not have any reason to believe that any tax provisions that are currently in law created any Enron problem or anything. So we do support the legislation. We supported it last year as part of the President's past tax bill.

Mr. DOGGETT. And support the provision that specifically encouraged some corporations—I believe the Wall Street Journal reported on Abbott potentially saving over $20 million and Pfizer saving over $20 million by merging their retirement plan into a K–SOP.

Mr. WEINBERGER. I have no knowledge of those facts. I can't even opine on that.

Mr. DOGGETT. Thank you very much. Thank you, Mr. Chairman.

Chairman THOMAS. Does the gentleman from Ohio, Mr. Portman, wish to inquire?

Mr. PORTMAN. Mr. Chairman, thank you. I will be brief. I was here at the outset, then had to go to a meeting, and I am back for the next panel, but have just a couple of questions for our panelists, first to thank them for the testimony today—and I read their statements—and for working with us to try to improve our pension system in the wake of what happened at Enron.

But I want to know a couple of things about where we have been in the last 20 years. How many 401(k)s were there in 1979?

Ms. COMBS. Since 401(k)s, the aggregate—today there are about 350,000 401(k) plans, so the growth has been——

Mr. PORTMAN. My point is that in the last 20 years we have gone from zero to over 300,000. How many million people, almost 43 million, are now in 401(k)s?

Mr. WEINBERGER. Correct. I could tell you there is a tenfold rise in the number of 401(k) plans, from 30,000 in 1985 to 301,000 in 1998.

Mr. PORTMAN. That is in a short period of time. My point is this has been a tremendous success for this Congress and for this country, and it has empowered employees because they have been able to take control of their own retirement. We still have half the workforce without a pension, and the last thing we should do is to put more rules and regulations on 401(k)s just at a time we are trying to expand them and other options, including defined benefit plans. And I would hope that in this hearing we can come up with ways to improve the retirement security of all employees by providing some common-sense changes to the law.

For instance, now with a 401(k) you can tie somebody down. In an earlier question from the Chairman, Ms. Combs mentioned that some plans do that. They all could do that. ESOP plans, of course, are limited to age 55 and 10 years of participation. But this is something that we believe ought to be addressed. There are different proposals as to how to do it. We want to work with you on that to not enable employers to tie people into corporate stock, instead to provide more information and education and disclosure and give people the option to get out of that corporate stock should they choose to do so.

I would also say that there are going to be a lot of different jurisdictional issues here. The Committee on Ways and Means is committed to working with the other committees to put together a good product. The Chairman has already talked about that. We think this is something that ought to be addressed this year. We want to be aggressive about it and continue the efforts we have made over the last 6 or 7 years in this Committee really to be a leader on expanding retirement security for all employees. Thank you for being here.

Chairman THOMAS. Does the gentleman from North Dakota, notwithstanding the fact he was prominently mentioned by the Assistant Secretary in his opening remarks, wish to inquire?

Mr. POMEROY. Yes, Mr. Chairman, briefly.

First of all, I would commend you for your statement, particularly as regards to me.

[Laughter.]

Mr. POMEROY. Further, I am certainly looking forward to the SAVER Summit coming up later this week. I was an original cosponsor, along with former colleague Harris Fawell, in passing the legislation initially. And I believed then and events have certainly shown that it is important not just to have one summit. This isn't a deal that you have a big event and it is all over. The challenge of getting Americans to adequately save and manage their assets for retirement is an ongoing challenge. It is one of the greatest priorities of this country, and it is going to become even more important. So pulling that together, especially in light of what a chaotic and eventful year our Nation has had, has been terribly difficult. I commend you, Secretary Combs, for doing that.

I want to tell you that I think that the reforms you have advanced, the Administration has advanced are balanced and constructive. I think that they are substantive and meaningful. There are a couple of fairly minor issues I would take with them. The 3-year diversification requirement, did you give any consideration to altering that based upon age of an employee? I mean, certainly someone at 50, a 3-year timeframe on diversification is more significant than someone at the age of 25. Any thought about age, linking that, making it shorter for someone older?

Ms. COMBS. We did look at age requirements. For instance, in the ESOP rules there is an age requirement of 55. So we looked at that and decided that with the mobility in defined contribution plans that may not make sense, that the motives really were employers wanted a demonstration that you were attached to their workforce and were going to accumulate a significant retirement benefit from that employer. And so our thought was to use 3 years as opposed to age-specific, but we did consider it, and we are open to discussing other approaches.

Mr. WEINBERGER. And again, Mr. Pomeroy, as I said earlier, obviously employers can do it sooner, but the 3 years was a close tie to the 3-year vesting requirements. We figured why let people diversify before they actually vest, and so that was part of the reason for the 3 years.

Mr. POMEROY. I do share your concerns that a percentage limit may have the unintended effect of actually reducing employer match, and the employer match is the greatest retiree savings incentive out there, bar none. And I do think we have really got to consider that as we look at percentage match limitations. I think your approach is simply more effective.

On the investment advice component of your plan, I would point you to a colloquy between Chairman Boehner and myself regarding some tweaking of the legislation passed by the House that would add some additional safeguards for participating employees, specifically more advanced and frequent fee disclosure, as well as a requirement that salespersons operating within this very restrictive fiduciary responsibility all have some type of administrative oversight. And so that would be licensure for securities and insurance, and after coming to more fully understand banking trust powers, you don't require licensure of bank trust employees. They have a very full array of administrative remedies sitting on them that could put them out of business if they violate their responsibilities.

But if you don't have it limited to trust department employees, you really don't have that type of administrative reach on bank personnel. So I would suggest that change as well. A fairly minor tweaking, but I think important to consumer protection.

Ms. COMBS. We are aware of the colloquy, and we do support the changes that you and Mr. Boehner agreed to.

Mr. POMEROY. Thank you.

Finally, there was a very interesting article in the Wall Street Journal yesterday, not the one mentioning you, Secretary Weinberger, but the one that talked about the company that voted to discount the earnings on its pension plan for purposes of corporate earnings to be considered in determining bonuses for company executives. The performance of the pension plan, which was fabulous during the stock market run-up, artificially bolstered corporate earnings in the balance statements for years. And it was a windfall to company personnel whose reimbursement was in part based upon performance measurements based on earnings because it was simply driven by the stock market on the pension program. This action by this company I thought was progressive and constructive.

Do you have any evaluation of this company's actions and whether it ought to be held up as a laudable example to others to consider?

Mr. WEINBERGER. I don't, but I will have a look at the article.

Ms. COMBS. I wasn't familiar with it either, but——

Mr. POMEROY. It is an interesting concept, isn't it? That as you determine compensation to be paid under some kind of bonus award, the earnings on the pension plan, having nothing to do with the company performance, aren't going to be considered. I like that idea. I thought it was appropriate. Thank you very much.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Texas, Mr. Brady, wish to inquire?

Mr. BRADY. Thank you, Mr. Chairman.

With 42 million workers in 401(k) plans, there is a lot at stake in this discussion. It is important that as we look at reforms that we consider them very carefully, that any changes be thoughtful so that we do this right, we not pass legislation in haste.

Although this hearing is not about Enron, it is hard to avoid it, and we have a number of ex-Enron employees in my congressional district. In meetings with them, and again last night, a townhall meeting with about 300 of the former workers gathered, we talked again and asked for their advice on reforms for pension issues.

And, again, repeatedly they said, look, don't limit our ability to invest in our company or any other company in our plans. What we want to know is if the auditors tell us the numbers are good on a company, we want to be able to rely on those numbers.

And I think the points you made earlier that the Administration is looking at reforms to make sure that audits truly are independent, that the numbers are closer to accurate, that they are something that people can rely upon, they can make informed decisions to build that nest egg that they want to build. And while there is interest in parity in blackout periods, more disclosure, more advice, issues like that, there seems to be a growing interest on their part, at least, to really see reforms on the accounting side of this to prevent it in the future.

But in dealing with them, one of the questions that comes forward often deals with current law protections if you are in these types of plans. From your information, what specific provisions exist under current law to protect workers in defined contribution plans? If an employer or a plan sponsor violates the law, what remedies are available to workers who participate in them? Are they all in the courts, or are there other laws as well?

Ms. COMBS. The defined contribution plans are subject to ERISA and its fiduciary standards, so that the plan sponsor and fiduciaries of the plan have a responsibility to act prudently, to act solely in the interest of the workers. There are prohibited transaction rules which prevent self-dealing. And there are remedies, both civil and criminal. On the civil side, fiduciaries are personally liable for losses that occur to the plan that are attributable to the breach that may have occurred to make the plan whole, plus interest so that it is truly made whole. And there are criminal penalties for behavior such as, as I mentioned, embezzlement, fraud, money laundering, wire fraud. So there is quite a broad—we have very broad subpoena power. We have a good investigative capability, and the protections are——

Mr. BRADY. How often, in addition to criminal penalties, how often—because we are asked this question often. What is the likelihood that when there is a fiduciary breach or fraud that occurs that it really results in some type of financial remedy for those who have been harmed?

Ms. COMBS. The Department of Labor, we opened approximately 4,000 investigations. It depends year by year, but it ranges between 4,000 and 5,000 investigations which are opened and completed each year. We recovered, for instance, in 2001 $662 million on behalf of participants.

Now, another important feature of ERISA which I neglected to mention is participants themselves have a right to bring a suit under ERISA. There is a private right of action. And I don't have—the statistics are not reported to us, but it is manyfold times the number of cases that we can bring, that the private bar is out there or private individuals are enforcing their rights under ERISA. So there is not only a deterrent effect, but there are some very serious consequences to breaching a fiduciary duty.

Mr. WEINBERGER. There is one more. Of course, the IRS could come in and disqualify a plan as well, which has major ramifications, if there are violations of the rules.

Mr. BRADY. From your perspective, are there any—what you basically said is we have got some strong protections. You aggressively enforce them. You go through a process to do that. As you look at that process, are there any reforms or changes that can be made to further strengthen that? Obviously, the more you have at stake in your fiduciary responsibility and the need to avoid fraud, hopefully the less likely that will occur.

Ms. COMBS. We think we have a good set of tools now, but we would be happy to work with the Committee to see if there are ways to provide additional strength.

Mr. BRADY. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman, and we have to be cognizant of the fact that there is a significant shared jurisdictional responsibility in this area.

I want to thank the panel. We will be seeing you again, and I would be willing to augment any name list, Mr. Weinberger, that you wish to present. I have some folks that I probably would like to have mentioned, and possibly some others not. I will work with you on your next presentation.

Thank you very much. The information that you provide to us will be essential in not only reviewing but obviously as we move forward legislatively. I want to underscore the gentleman from California's—Mr. Matsui's concern about the timeliness of providing us with this information.

I would ask the next panel—first of all, I want to thank the upcoming panel for their patience. The information that you are to provide us is extremely valuable.

The second panel consists of Mr. Vanderhei from Temple University; Mr. Schieber, Vice President, Research and Information, Watson Wyatt Worldwide; and Regina Jefferson, a Professor of Law at Catholic University.

We have your written statements, and we will make them a part of the record, without objection. And if you will address us in the time you have available in any way you desire to inform us, we will listen to you and then we will follow with some questions.

Why don't we start with Mr. Vanderhei and then simply move across the panel.

STATEMENT OF JACK L. VANDERHEI, PH.D., FACULTY MEMBER, RISK INSURANCE AND HEALTH CARE MANAGEMENT, FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PENNSYLVANIA, AND RESEARCH DIRECTOR, FELLOWS PROGRAM, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. VANDERHEI. Thank you. Chairman Thomas, Ranking Member Rangel, 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 in 401(k) plans. I wish to note that the views expressed in this statement are mine alone and should not be attributed to my co-authors, 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 Employee Benefit Research Institute/Investment Co. Institute (EBRI/ICI) 401(k) database—a 5-year collection 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, as noted earlier, the plans that do have——

Chairman THOMAS. Mr. VanDerhei, if you would suspend just briefly.

If people want to carry on conversations, I would appreciate it if they would remove themselves from the Committee room so the Committee could hear the testimony.

Mr. VANDERHEI. However, as noted earlier, 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 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 the 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 these plans have more than 20 percent of their account balances invested in company stock. That percentage decreases to 41 percent for participants in their sixties.

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 would be the employer, a government agency—perhaps the PBGC—and/or a private insurance company. While the cost of the guarantees and/or the 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, if you will, a proposal that would require the employer to insure 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 that new risk imposed by the minimum guarantee would be to force all contributions—whether contributed by the employee or by 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 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 its 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 in 401(k) account balances 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 of minimum guarantees and assumed asset allocations and rates of return.

Finally, number six, what happens if company stock were removed from 401(k) plans? I simulated the overall gain or loss from prospective retention of company stock in 401(k) plans, as opposed to company stock being entirely eliminated immediately, for birth cohorts between 1936 and 1970, and 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, however, be a wide distribution of winners and losers from retaining company stock. For example, at least 25 percent of the sample is expected to gain 5.1 percent or more if they were allowed to have company stock going forward, while at least 25 percent of the sample is expected to lose 10.8 percent or more if company stock continues to be permitted.

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 prepared statement of Mr. VanDerhei follows:]

Statement of Jack L. VanDerhei,* Ph.D., Faculty Member, Risk Insurance and Health Care Management, Fox School of Business and Management, Temple University, Philadelphia, Pennsylvania, and Research Director, Fellows Program, Employee Benefit Research Institute

1 Introduction

Chairman Thomas, Ranking Member Rangel, 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 [1]

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 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

---

*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.

[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.

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

---

[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/TIAA–CREF/Stanford University), forthcoming. (*www.brook.edu/es/erisa/99papers/erisa2.pdf*)

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.

---

[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.

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

[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.

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

---

[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.

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

[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.

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.

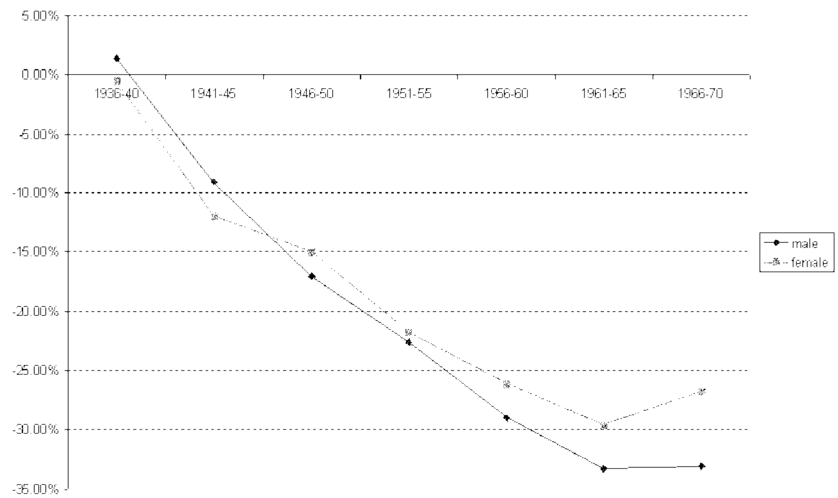
Figure 2 shows the expected results of running one such proposal through the EBRI/ERF Retirement Income Projection Model. Instead of allowing employees to direct their own contributions and perhaps those of the employer, assume employers are forced to guarantee a minimum rate of return of five percent 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.

[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.

Figure 2 Expected change in average 401(k) account balances if all participants were to prospectively change to a guaranteed investment yielding 5 percent nominal, by gender and year of birth (see text for assumptions of asset allocation under status quo)



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.

Chairman THOMAS. Thank you, Doctor.
Mr. Schieber.

STATEMENT OF SYLVESTER J. SCHIEBER, VICE PRESIDENT, RESEARCH AND INFORMATION, WATSON WYATT WORLDWIDE

Mr. SCHIEBER Mr. Chairman, Members of the——

Chairman THOMAS. You need to turn your microphone on, and then it is very unidirectional.

Mr. SCHIEBER Sorry. Mr. Chairman, Members of the Committee, thank you——

Chairman THOMAS. You need to pull the mike down and speak directly into it. It is very unidirectional.

Mr. SCHIEBER Thank you very much for the opportunity to testify here today. The comments I am giving are my own. Recent developments have raised concerns about the operation of employer-sponsored defined contribution plans suggesting the need for additional regulation. I begin my testimony with a caution against doing anything that jeopardizes the extremely robust and resilient element of our retirement system.

I believe that ERISA has done much to improve the retirement prospects of millions of workers in this country. But I also believe that the over-regulation of pensions during the 1980s and the early 1990s led to fewer pensions and drastic changes in the sorts of plans that were offered. In my prepared testimony, I cite research that supports this conclusion. On balance, regulation is important, but over-regulation is potentially counterproductive.

Public accounts of Enron employees losing their retirement savings as their employer plunged into bankruptcy last year have raised concerns about 401(k) plans generally. Remarkably less has been said about what happened to the defined benefit savings of workers in this same case.

One of the concerns arising from recent developments is that employers are forcing employees to hold employer stock in their 401(k) accounts, subjecting them to excessive risk. There are two issues here. First is the extent to which workers are forced to hold company stock. Second is the extent to which workers' retirement security is at risk because of insufficient diversification.

Most of the company stock that Enron employees held in their 401(k) plan was there at employee discretion. Ignoring for the moment the trading blackout period, these workers were not precluded from selling most of their employer stock. There may be three potential explanations for why Enron employees did hold so much of their 401(k) balance in the company stock. One is that they here misled about the potential performance of the stock. Second is that they did not understand the risks associated with investing in a single company's stock. Third is that they knew there were downside risks from holding so much in Enron stock, but perceived the upside potential outweighed the cost of taking the risk.

To the extent that workers are duped into buying a particular company's stock by the senior management of a company, there are already SEC rules on what corporate managers can tell any potential investors in their stock. If these rules are being violated or were violated in this case, the senior managers who violate them should be prosecuted to the maximum extent possible.

If the problem with 401(k) plans is that employees do not appreciate the risks that they take on in investing heavily in their employer's stock, it can be addressed in one of two ways. One is more education. The other is imposing limits on the employer stock that workers can hold in their 401(k) accounts. While the latter approach might be more effective from the perspective of an enlightened regulator, I would caution that what seems enlightened here in Washington sometimes seems less so outside the Beltway.

This leaves a question of whether we should restrict employees who understand their employer's financial prospects and understand the risks associated with investing in a single stock from investing most or all of their 401(k) balances in their employer's equities. Keep in mind that workers feel strongly that the assets in their retirement accounts are theirs. Next to the basic freedoms we enjoy in this country, property rights are something we guard with tremendous fervor.

For ever business failure where employees have lost most of their funds from investing in their employer's stock, there are many other examples of employees in other companies who have done well voluntarily investing in this way. Prohibiting workers from investing their retirement money in the assets they wish to invest in will likely create a public outcry that policymakers ought to seriously consider before they adopt restrictive regulations in this area.

As we move toward legislative change, I urge caution. I applaud the prior efforts of Representatives Portman and Cardin, Earl Pomeroy, and others on this Committee who have been very mindful about trying to adopt rules or modify rules to expand the system.

Given the track record of plan growth, worker participation, and overall saving in 401(k) plans, we should attempt to solve existing problems without creating new ones.

As a matter of public policy, I believe that the absolute restrictions on the amount of employer stock a worker can hold in his or her retirement savings account will cause a strong adverse reaction on the part of plan sponsors and participants and is not warranted.

I am sympathetic to the argument that workers' vested benefits in their retirement plan are an economic asset intended to secure their retirement needs. As such, the ability for anyone to dictate that such assets be invested in a particular way should be limited.

Given the growing dependence of American workers on the 401(k) plans, any effort to provide more information about appropriate investment behavior should be favorably considered. Keep in mind, however, that many plans are offered by small employers or in highly competitive environments where budgets are limited. We do not want to relearn the lessons of the 1980s that too much regulation leads to fewer plans rather than more security in the plans that already exist.

Finally, any provisions that seek to provide guaranteed returns in these plans should be viewed with a wary eye. I cannot think of any single policy change that would have the potential to so radically alter the landscape of our retirement system in an adverse way. If this guarantee is going to be foisted on employers, policymakers should expect to see a significant exodus of sponsors from offering plans. If the Federal Government is going to establish and run such a program, policymakers should have a full understanding of the costs involved in it and who is going to be assessed these costs. And I warn you, if it is the workers who are going to be assessed these costs, you are going to have a public outcry over these plans that you haven't seen since discussions about tax reform back in the mid-1980s. Thank you very much.

[The prepared statement of Mr. Schieber follows:]

Statement of Sylvester J. Schieber *, Vice President, Research and Information, Watson Wyatt Worldwide

Mr. Chairman and members of the Committee on Ways and Means, I am Sylvester J. Schieber, Vice President of Research and Information at Watson Wyatt Worldwide. I am testifying today on issues regarding *Retirement Security and Defined Contribution Plans.* My comments are my own and do not reflect those of Watson Wyatt Worldwide, or any of its other associates.

I have spent more than 30 years studying the retirement systems in the United States and elsewhere around the world. I understand why there are concerns today about the retirement security system in this country and specifically about the operation of employer-sponsored defined contribution plans given recent developments. But I would like to begin by cautioning the members of this Committee and other members of Congress against doing anything that jeopardizes an extremely robust and resilient element of our retirement system.

I firmly believe in the importance of public policy in regulation of employer sponsored retirement plans. I believe that the Employee Retirement Income Security Act (ERISA) has done a great deal to improve the retirement prospects of millions of

*The opinions and conclusions stated here are the author's and should not be construed to be those of Watson Wyatt Worldwide or any of its other associates.

workers in this country. But I also believe there is strong evidence that the over regulation of pensions during the 1980s and early 1990s led to the reduction in the availability of pensions and to drastic changes in the sorts of plans that have been offered to workers. In other words, I believe regulation is important but that over regulation is potentially counterproductive.

Today, many people are concerned about the risks associated with defined contribution plans and would saddle these plans with new sets of requirements, restrictions, and expenses in order to ameliorate such risks. A significant problem, however, is that the reduction of current risks in these plans has the potential to create another set of risks for them and their participants. In highlighting the recent concerns about defined contribution plans, much has been said about these plans and others that is very misleading and has the potential to result in the development of bad public policies. I am concerned that such policies might lead to the curtailment of plans in the short term with a long-term result that few would consider appropriate or desirable.

Prior Evidence on the Importance of Regulation

Nearly 10 years ago, Professor John Shoven of Stanford University and I presented a paper at a policy conference here in Washington, DC, that analyzed the implications of pension funding restrictions that had been imposed on private sector employers during the 1980s and 1990s.[1] Our analysis concluded that these policies had significantly delayed the funding of pension obligations for the baby boom generation of workers and would ultimately result in much higher costs to employers than if prior rules had been left in place. We suggested the implications of these policies were likely to be adverse to the pension prospects of baby boomers. At the conference when we first presented our paper, a policy analyst from the Department of Labor suggested the implication of our analysis was simply that employers would have to contribute more to their pension plans late in the baby boomers' careers than under prior funding regulations. We observed that there was an alternative prospect that employers might simply curtail their defined benefit plans as the delayed liabilities came due. I believe that there is strong evidence over the past decade that our concerns about the potential curtailment of private defined benefit plans were well founded. I am convinced that public policy has played a major role in what has transpired.

In a subsequent policy paper that Professor Robert Clark of North Carolina State University, a colleague of mine at Watson Wyatt Worldwide, Janemarie Mulvey, and I wrote, we analyzed the effects of pension nondiscrimination rules on private sector pension participation.[2] In an effort to prevent plan sponsors from targeting tax benefits accorded pensions to high-wage employees, Congress established nondiscrimination standards that require employers to include a wide range of workers in pension plans in order for these plans to achieve tax-qualified status. In addition, regulations have been introduced to limit maximum benefits to high-income workers and to restrict the integration of pension benefits with Social Security. The objective of these nondiscrimination rules has been to increase the participation rate of low-wage workers while limiting the loss in tax revenues associated with benefits to highly paid employees.

In our analysis, we examined changes in pension coverage rates between 1979 and 1998 to determine if the absolute and relative participation of low-wage workers increased following the implementation of new, more restrictive nondiscrimination standards adopted during the 1980s. In our analyses, we found no support for the hypothesis that more restrictive discrimination rules forced or enticed employers to provide pensions to low-paid workers. Participation rates for low earners simply did not rise in absolute terms or relative to the participation rates of high-wage workers following the implementation of new standards.

These new nondiscrimination standards along with other pension regulations have increased the cost of providing pensions. We showed in our analysis that in many cases, the administrative costs associated with government regulation of employer-sponsored plans can exceed the tax advantage of pension saving for workers

[1] This paper was first presented at a conference during September 1993 and was subsequently published in Sylvester J. Schieber and John B. Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets," in Sylvester J. Schieber and John B. Shoven. eds., *Public Policy Toward Pensions* (Cambridge, MA: The MIT Press, 1997), pp. 279–246.

[2] Robert L. Clark, Janemarie Mulvey, and Sylvester J. Schieber, "The Effects of Pension Nondiscrimination Rules on Private Sector Pension Participation," in William Gale, John Shoven, and Mark Warshawshky, eds., *Public Policies and Private Pensions* (Washington, DC: The Brookings Institution, 2002 forthcoming). Until released in its published form this paper may be found at: http://www.watsonwyatt.com/progress__files/whitepapers/wp-05.pdf.

at lower pay levels especially in smaller plans. As a result, it is not surprising that many small employers terminated defined benefit plans over the past two decades. This indirect effect of these regulations is one of the reasons that participation rates of low-income workers have remained relatively low.

Administrative costs are a disincentive for employers to provide pension coverage to low-income workers. Yet, most of the legislative efforts aimed at increasing participation have actually increased the regulatory burden to employers and thus their overall administrative costs. In reality, these regulations have done little to increase participation among low-wage workers over the past twenty years. Workers at low and middle earnings levels actually experienced small declines in pension participation following the adoption of these regulations. If Congress wants to expand participation for low-income workers it should look for ways to reduce, rather than increase, the regulatory burdens on employers.

Recent Developments and the Need for New Regulation

A renewed awareness of the fragility of our retirement system has arisen from a number of public accounts of Enron employees losing their retirement savings as their employer plunged into bankruptcy late last year. Remarkably less has been said about what happened to their defined benefit savings. A widely published problem in this case was that many Enron employees had invested most, if not all, of their 401(k) assets in Enron stock. To further complicate a bad situation, it appears that the most senior managers in Enron encouraged workers to buy Enron stock even after they became aware of the likelihood that the company was in financial peril. This combination of problems was further exacerbated by the fact that the participants in the Enron 401(k) plan had gone through a blackout period when they could not sell the Enron stock in their plan during a period when the value of the stock was plunging. This latter situation arose because of a shift from one plan administrator to another. And finally, to add insult to injury, the senior managers in Enron are reported to have been selling substantial blocks of Enron stock at exactly the same time the rank-and-file employees were trapped in the blackout on selling the Enron stock in their 401(k) accounts.

Out of this situation several proposals have evolved that would limit the exposure that employers could impose on workers to employer stock in their 401(k) plans. Other proposals would require certain communication with workers. There have even been proposals that we adopt some sort of benefit insurance covering defined contribution plans that would be similar to the insurance protection provided to participants in defined benefit plans through the Pension Benefit Guaranty Corporation (PBGC). Before turning to an assessment of the policy proposals, it is important to put some facts on the table regarding the demise of the Enron 401(k) plan and the general situation of 401(k) plans.

One of the concerns arising out of Enron is that employers are forcing their employees to hold their stock in their 401(k) accounts and thus putting them at excessive risk in terms of their retirement security. The risk to retirement security comes partially from over concentration in a single stock but is exacerbated by the correlation with employment risks associated with employers that go bankrupt. In other words, the employees at Enron faced double jeopardy as the company went bankrupt—they not only lost much of their retirement security they also lost the security of their existing jobs. There are two issues here that are important. The first of these is the extent to which workers are forced to hold company stock. The second is the extent to which their retirement security is at risk because their retirement portfolio is not sufficiently diversified in the assets securing it.

While there may be a misperception about the case, the fact is that most of the company stock that Enron employees held in their 401(k) plan was there at the employees' discretion. Ignoring for the moment, the blackout period, Enron workers in the plan were not precluded from selling most of their employer's stock and buying some other financial security. There may be three potential explanations for why the workers in this case held so much Enron stock in their 401(k) portfolios. One is that they had been misled about the potential performance of the stock in the future relative to alternative investment options. Second is that they did not appreciate the risks associated with investing in a single company's stock. Third is that they knew there were downside risks but perceived the upside potential outweighed the cost of taking the risk of investing heavily in Enron.

To the extent that workers were duped into buying Enron stock because senior management in the company was misleading them about the prospects of the company's performance, there are already Securities and Exchange Commission rules on what senior managers of publicly traded corporations can tell any potential investors in their stock. If these rules were violated, the senior managers who violated them should be prosecuted to the maximum extent possible. If a thief on the street who broke into Enron employees' or executives' homes is subject to prosecution, mandatory sentences including three-strike rules, and lengthy jail time, any thieves stealing from retirement plans should be just as subject to the same potential punishment. While the SEC might need to beef up accounting and disclosure rules, the best deterrent to protect 401(k) plan participants from corporate managers who mislead them about the prospects of their companies might be vigorous enforcement of existing laws.

There is some likelihood that Enron employees and many other employees around the country do not appreciate the risks they take on in investing heavily in their employer's stock, especially in doing so in their retirement plans. This problem can either be addressed by providing more education for workers or by imposing limits on them in terms of the extent to which they can buy their employers' stock through their 401(k) plans. While the latter approach might be the more effective one from the perspective of an enlightened regulator, I would caution policymakers from rushing headlong into this approach. What seems enlightened from the perspective of Washington, sometimes seems less so outside the beltway.

This leaves us with a question of whether we should restrict employees who are not misled about their employer's financial prospects and who understand the risks associated with investing in a single company's stock from investing most or all of their 401(k) assets in that stock. I believe that one of the strongest aspects of the 401(k) system in the United States is the sense of ownership that workers have in the programs. Workers are adamant that the assets in their retirement accounts are theirs. Next to the basic freedoms we enjoy in this country, property rights are something that we guard with tremendous fervor.

For every Enron where employees have lost most of their funds from investing in their employer's stock, there are many other examples of employees in other companies who have done very well over extended periods of time by voluntarily investing in their employers' stock. Prohibiting workers from investing their retirement money in the assets they wish to invest in has the potential to create an adverse public outcry that policymakers ought to seriously consider before they adopt restrictive regulations in this area. You might recall that during the debates over tax reform during the mid-1980s that both the Reagan Administration and the Chairman of the Ways and Means Committee entertained proposals to restrict 401(k) plans that were quickly abandoned when workers voiced their displeasure *en masse*.

One of the problems that we face in devising limits that protect 401(k) participants is the highly variable set of circumstances under which these plans are offered. In some cases, employers offer their 401(k) plan as a supplement to a relatively generous defined benefit plan. In others, it is the only retirement saving vehicle the company offers. If an employer has a defined benefit plan that in combination with Social Security provides career workers with pension annuities that allow them to maintain preretirement standards of living, what risks to their retirement security do workers pose when they invest their 401(k) assets in employer stock? Even in cases where workers are predominantly dependent on their 401(k) savings for retirement, there are tremendous differences in the risks associated with investing in company stock at ages 25, 35, 45, or 55. How do you control for those in setting rules limiting where workers can invest their retirement assets?

Insuring Against Risk in Defined Contribution Plans

Going beyond simply limiting where employees can invest their 401(k) retirement funds, some policy analysts are now advocating that we actually insure the investment performance in these plans. The argument here is that the insurance guarantee provided to defined benefit participants is the equivalent of a minimum investment return guarantee. If the government is going to be the insurer of one sort of plan, then why not the other. Indeed, cash balance plans are insured under the PBGC and basically insures the implied rates of return on these plans.[3] There are several problems with this logic and the proposals that flow out of it.

First of all, the argument that insuring investment performance in a defined contribution plan with participant-directed investment and insuring benefits in a defined benefit plan are equivalent is far fetched. The PBGC insures benefits only in cases of bankruptcy resulting in the inability of a pension sponsor to pay promised benefits under the plan. In cases where the insurance comes into play, the PBGC has a claim against any residual assets in the sponsoring company. This insurance is provided in conjunction with a stringent set of funding requirements and variable premiums that seek to entice if not force plan sponsors to keep asset levels in the plan at roughly the level of liabilities that exist within them. Adverse experience

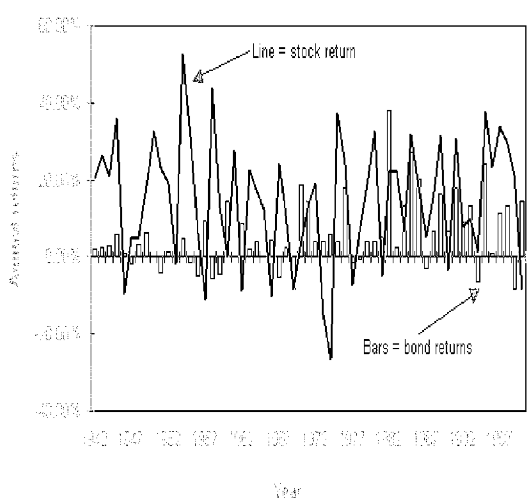
[3] Regina T. Jefferson, "Rethinking the Risk of Defined Contribution Plans," *Florida Tax Review* (2000), vol. 4, no. 9.

in the investment of the assets in these plans does not trigger an insurance payment by the PBGC, it triggers added contributions on the part of plan sponsors. Even in cash balance plans, the plan sponsor's failure to realize rates of return on plan assets that are as high as the credited rate of return on the notional accounts has to be made up with added sponsor contributions.

In a defined contribution world, the provision of similar insurance to that provided in the defined benefit world would conceivably put the employer in the position of being the insurer of first resort. Most of the employers who were motivated to shift from offering defined benefit plans to offering defined contribution plans because of their unwillingness to accept investment risks in retirement plan sponsorship would likely quit offering plans. Those that continued to offer them would likely move back toward a highly restricted set of investment options in their plans. In the early days of 401(k) plans much of the investment was in guaranteed investment contracts (GICs) or similar instruments that paid relatively low fixed rates of return over the long term. In part, the move to self-directed investment in these plans was the result of workers wanting the higher returns from more aggressive investment that plan sponsors were not willing to pursue directly with their employees' vested account balances.

The problem here cannot be diversified away. Figure 1 shows the variability in annual nominal returns payable to investors in broad stock or bond indexes in the United States between 1942 and 2000. Over the period shown, the average return on the S&P 500 index fund was 14.6 percent per year compared to 5.8 percent per year for the bond fund. But the volatility in the stock fund, as measured by the standard deviation of the historical returns, was also higher at 16.5 percent compared to 9 percent for the bond fund. Workers want the higher returns over time they seemingly get from investing in stocks, but employers are unwilling to take on the added risks associated with investing in stock to provide these higher returns.

Figure 1: Annual Returns from the Standard and Poors 500 Stock Index Including Dividends and from an Index of U.S. Ten-Year Treasury Bonds



Source: Derived by Olivia Mitchell and Marie-Eve Lachance, Wharton School, University of Pennsylvania.

The advocates of providing some sort of return guarantee in defined contribution plans argue that by setting up cash balance plans, employers have demonstrated they are willing to provide such guarantees. But these advocates ignore that employers have imposed a relatively heavy price on participants when they provide return guarantees in these plans. In data we have gathered on approximately 120 cash balance plans, two-thirds of them provided interest credits at the equivalent to either the consumer price index rate or some federal bond rate. A number of others had fixed credit rates that were even lower than federal bond rates. It is highly unlikely that the majority of 401(k) participants would be willing to accept a guaranteed rate of return at such a steep price.

If the Federal Government is going to provide this insurance instead of attempting to force employers to do it, it would almost certainly mean the creation of some sort of pooled account with centralized administration. Even if we were willing to create such an entity, it is not clear that policymakers would be willing to impose the price of return guarantees on participants. In fact, President Bush's recent Social Security Commission considered some sort of return guarantees for the individual accounts created in the Social Security reform options they devised. But the Commission did not include a guarantee in any of its reform options. In large part, the Commission members thought the cost would be too high to guarantee returns in this sort of program.

If we can figure out the mechanism for providing investment insurance, it would still mean a radical reorientation of the investment of assets in these plans. If we allowed the current method of investment to persist along with an investment return insurance program, we would create a tremendous moral hazard situation. If I know that I have a large up-side potential from pursuing a risky investment strategy but realize that I have little downside exposure because of the insurance program, then why would I do anything but pursue the risky strategy? I would accrue all the benefits of such an approach and the insurer would sustain all the risks.

Making Defined Contribution Benefits More Secure

In his State of the Union Address this year, President Bush noted the public concern about 401(k) plans that has arisen out of the Enron bankruptcy situation. He has formed a task force including the Secretaries of Treasury, Labor, and Commerce to develop new safeguards for these plans. The President has recommended that workers be given greater freedom to diversify and manage their retirement funds; that corporate managers be restricted in their ability to trade company stock during 401(k) trading blackout periods; that workers be given quarterly information on their asset balances; and that they be given more access to investment advice. While the Bush Administration has not put forward specific legislation, a bill that has been introduced by Representatives Rob Portman (R–OH) and Benjamin Cardin (D–MD) would substantially cover the principles that have been laid out by the President.

In some regards, it is regrettable that any new restrictions have to be put on these plans as the track record they have achieved is remarkable. Where plans are offered, 70 to 80 percent of eligible workers participate in them. Total contributions going into these plans equal 8 to 9 percent of pay.[4] Jim Poterba, Steven Venti, and David Wise estimate that by 2030 the 401(k) system in the United States will be generating retirement benefits that are larger than Social Security.[5] In other words, this totally voluntary system has the potential to completely outstrip Social Security in terms of aggregate benefit delivery by 2030, a only half century after the first plan was put in place. On a totally voluntary basis it will outstrip the government program that requires more in tax revenue to support it than any other government program. The 401(k) system is so admired or envied by policymakers elsewhere in the world that other countries are moving to implement similar programs. Germany and Japan recently adopted systems that seek to mimic ours to a considerable extent. We should be very careful about doing anything that jeopardizes this system.

As a matter of public policy, I believe that absolute restrictions on the amount of employer stock a worker can hold in his or her retirement savings account will cause a strong adverse reaction on the part of plan sponsors and participants and is not warranted. Employers use their benefit programs for a variety of purposes and they use them in combination to attract, retain, and motivate workers. Providing matching contributions in the form of employer stock is one tool that employers have in achieving their goals. Employees in successful companies, often seek to participate in some of the benefits of that success beyond simply taking home a paycheck. Our research suggests that companies with higher levels of employee ownership of stock generally out perform those where employees do not have such a financial interest.[6] The success of our economy, the labor markets, and the growth of retirement saving over the period since 401(k) plans have come into operation high-

[4] Robert L. Clark, Gordon P. Goodfellow, Sylvester J. Schieber, and Drew Warwick, "Making the Most of 401(k) Plans: Who's Choosing What and Why," in Olivia S. Mitchell, P. Brett Hammond, and Anna M. Rappaport, eds., *Forecasting Retirement Needs and Retirement Wealth* (Philadelphia: University of Pennsylvania Press, 2000, p. 104.

[5] James M. Poterba, Steven F. Venti, and David A. Wise, "401(k) Plans and Future Retirement Patterns," *American Economic Review* (May, 1998), p. 183.

[6] Watson Wyatt Worldwide, *Human Capital Index* (Washington, DC, 2001), p. 5.

light the reason we should be wary of adopting any massive overhaul of the 401(k) system.

While I oppose restrictions that would preclude workers from freely investing in their employers' stocks, I am sympathetic to the argument that a workers' vested benefits in their retirement plan are an economic asset intended to secure their retirement needs. As such, the ability for anyone to dictate that such assets be invested in a particular way should be limited. Some employers may be unhappy that such restrictions might limit their ability to give workers a vested interest in the success of their organizations. If the new restrictions do not include absolute limits, however, good companies will still be desirable places for workers to invest. Like many other aspects of the organization of our economy, this requirement will place an added premium on good management, but it is good management of our private sector businesses that has made our economy such a dominant force in the world.

Given the growing dependence of American workers on the accumulating balances in their retirement savings plans, any effort to provide them with more information about the appropriate investment behavior should be favorably considered. As with many things in life, however, retirement savings plans are often offered by small employers or in highly competitive environments where lavish budgets to provide extensive communication and investment advice are limited. We do not want to relearn the lessons of the 1980s that too much regulation leads to fewer plans rather than more security in the ones that already exist.

Finally, any provisions that seek to provide guaranteed returns in these plans should be viewed with an extremely wary eye. I cannot think of any single policy change that would have the potential to so radically alter the landscape of our retirement system in an adverse way. If this guarantee is going to be foisted on employers, policymakers should expect to see a significant exodus of sponsors from offering plans. If the Federal Government is going to establish and run such a program, policymakers should have a full understanding of the costs involved in it and who is going to be assessed those costs.

Chairman THOMAS. Thank you very much, Mr. Schieber. Professor Jefferson?

STATEMENT OF REGINA T. JEFFERSON, PROFESSOR OF LAW, COLUMBUS SCHOOL OF LAW, CATHOLIC UNIVERSITY OF AMERICA

Ms. JEFFERSON. Good afternoon, Chairman Thomas, Congressman Rangel, and Members of the Committee. I am Regina Jefferson, a Professor of Law at the Catholic University of America. Thank you for inviting me here today to testify on retirement security and defined contribution plans.

The collapse of Enron has drawn attention to the need for diversification in 401(k) plans. However, the use of defined contribution plans as primary retirement saving vehicles presents an array of concerns that extend beyond this limited issue.

In my testimony, I identify some of the problems defined contribution plan participants face under current law that have not been addressed in the Enron discussions. In connection with these weaknesses, I make recommendations for regulatory changes.

Specifically, I focus on the need for residual fiduciary liability for employers who sponsor participant-directed plans, a minimum education standard, and the establishment of defined contribution plan insurance. The ideas presented in my testimony are explained in greater detail in an article I wrote entitled "Rethinking the Risks of Defined Contribution Plans."

Notwithstanding the significant ramifications of investment decisions and the fact that most participants lack training to allocate their assets, ERISA imposes no additional education or notification requirements on employers who sponsor participant-directed plans. Generally, employers are not responsible for the investment decisions made by participants if the plan provides a broad range of investment choices. Consequently, in participant-directed plans, the employer's liability as an ERISA fiduciary for poor investment performance is substantially reduced, rendering many of ERISA's fiduciary rules irrelevant.

The self-help characteristic of participant-directed plans is inconsistent with ERISA's goal of increasing retirement security. Furthermore, the economic benefits enjoyed by employers who establish retirement plans presumably are unwarranted if participants are no better off covered by the plan than they would be saving on their own. Therefore, to justify the retirement system's costs, as well as to increase retirement security, residual fiduciary liability should be imposed on employers who sponsor participant-directed plans.

To avoid residual liability for plan losses, employers would be required to provide investment education and notification to participants who use less than optimum investment strategies.

Because the success or failure of the participant-directed plan depends upon the participant's ability to properly allocate assets, employers should be required to provide a minimum level of investment education that will enable most participants to make decisions consistent with recommended guidelines, as well as to appreciate the future value of their expected retirement benefits. Additionally, a minimum standard would provide consistent education throughout the private retirement system. The education requirement should mandate a variety of educational mediums. There is substantial evidence showing that printed communications generally are ineffective in aiding the investment education of plan participants because employees either do not understand them or disregard them. Therefore, the education provided by employers should be non-generic and should include a complement of written materials, seminars, and financial planning software.

There also should be insurance for defined contribution plans comparable in amount and objective to that provided defined benefit plans. Although defined benefit plans are insured by the Pension Benefit Guaranty Corporation, there is no insurance for defined contribution plans because the benefits are determined by contributions and investment performance.

Interestingly, the effects of poor investment performance in defined contribution and defined benefit plans are very similar. Consequently, reluctance to insure investment performance in defined contribution plans is based more on perception than reality.

The similarity of the impact of poor investment performance in the two types of plans can be illustrated best if one considers a defined benefit plan in which all actuarial assumptions used in the funding process are correct, except for the interest assumption. Therefore, if the plan terminates with insufficient assets, benefit losses would be solely attributable to unfavorable investment performance. Thus, to the extent that the PBGC guarantees payment of the benefits in such a plan, it effectively insures an average investment return over the plan's life.

In the article I wrote, I proposed a risk-based, voluntary insurance program for defined contribution plans that would protect participants against similar risks of shortfalls. Under this proposal, annual guaranteed rates of return would be determined by a prescribed diversification formula, which would define an acceptable range of complementary allocations with respect to investment category and risk classification. The proposed insurance would protect participants against severe market contractions to the extent that their accounts were in compliance with the formula.

Accordingly, if the market took a sudden downturn immediately preceding a participant's retirement, the insured participant would be guaranteed at least an average return on her aggregate contributions payable at normal retirement, notwithstanding her actual account balance.

This concludes my testimony, and I thank you for the opportunity to express these important concerns.

[The prepared statement of Ms. Jefferson follows:]

Statement of Regina T. Jefferson, Professor of Law, Columbia School of Law, Catholic University of America

Mr. Chairman, and Members of the Committee, I am Regina Jefferson, a professor of law at The Catholic University of America, Columbus School of Law located in Washington D.C. I thank you for the opportunity to share my views about the adequacy of existing protections for defined contribution plans under current law. At The Catholic University of America, I teach federal income taxation of individuals and partnerships, and pension and employee benefits law. My research and scholarship address issues of taxation, pensions, and related topics.

Since the passage of ERISA, the composition of the private pension system has changed dramatically. In recent years, there has been discernable movement towards using defined contribution plans instead of traditional defined benefit plans as primary retirement savings vehicles. This trend has serious implications for the private pension system because it shifts the risk of accumulating insufficient retirement assets from the plan sponsor to the plan participant. As a result of this development, many of the protective measures introduced by ERISA are ineffective or inadequate. The collapse of Enron highlights the diversification problem; however, problems with defined contribution plans extend far beyond this issue. Unless the pension law is amended in other areas as it applies to defined contribution plans in general, and participant directed defined contribution plans in particular, many more participants may suffer plan losses of the same magnitude that Enron employees experienced.

In my testimony, I will identify some of the problems that a defined contribution plan participant faces in accumulating targeted amounts for retirement, that have not been discussed in the wake of Enron. I will also make recommendations for regulatory changes that would correct these deficiencies. Specifically, I will focus on the need for: (1) residual fiduciary liability for employers who sponsor participant directed defined contribution plans; (2) a minimum education standard for employers who sponsor participant directed plans; and (3) the establishment of a defined contribution plan insurance program comparable in amount and objective to the existing defined benefit plan insurance program. The ideas presented in my testimony are explained in greater detail in an article I wrote entitled *Rethinking the Risks of Defined Contribution Plans.*[1]

I. Residual Fiduciary Liability in Participant Directed Plans

To provide the level of retirement income security envisioned by ERISA as originally drafted, there should be residual fiduciary liability imposed on employers who sponsor participant directed plans.

Although employers who sponsor defined contribution plans are not required to allow participants to make individual participation and investment decisions, many employers recognize that giving flexibility enables employees to customize their retirement programs to accommodate their specific savings objectives and risk toler-

[1] Regina T. Jefferson, Rethinking the Risks of Defined Contribution Plans, 4 Florida Tax Review 607 (2000).

ances. Thus, the growth in the defined contribution plan area has been driven largely by the establishment of participant directed plans, also known as 401(k) plans. In these plans, employees are required to decide not only whether to participate, the level of contribution to be made on their behalves by the employer, but also the manner in which their accounts are to be invested.

Notwithstanding the complexity of making investment decisions, ERISA imposes no additional education or notification requirements on employers who sponsor participant directed plans. Only the general fiduciary standards of ERISA govern these plans. ERISA defines a "fiduciary" as a person with discretionary authority or control over the plan assets, or a person who manages the plan assets. Thus, because employees make the investment decisions in participant directed plans, the employer's liability as a plan fiduciary for poor investment performance is substantially reduced. This reduction of liability renders many of ERISA's general fiduciary rules regarding asset investment and management irrelevant.

To further minimize liability for poor investment performance, many employers establish section 404(c) "safe harbor" plans. In safe harbor plans, an employer's exposure to fiduciary liability is even further reduced, if the plan satisfies applicable rules and regulations. These rules require the employer to give a broad range of investment options, and reasonable instructions regarding the significance of the options. Unlike, traditional participant directed plans in which plan fiduciaries retain a limited obligation to make sure that the plan assets are protected against losses, section 404(c) safe harbor plans essentially shield the employer and other plan fiduciaries from such liability. Consequently, in these plans fiduciaries generally are not liable for losses that result from poor investment returns, regardless of the manner in which plan participants allocate their assets.

Therefore, participant directed plans raise serious questions about the adequacy of ERISA's fiduciary rules. In a tax subsidized retirement system, is it appropriate to allow employers to shift the responsibility of making critical investment decisions to plan participants who typically lack professional financial training? Section 404(c) safe harbor plans raise even more concerns regarding the adequacy of ERISA's fiduciary rules, because in these plans the employer and other plan fiduciaries are almost entirely insulated from fiduciary liability for poor investment decisions made by plan participants.

Employers are encouraged to establish qualified retirement plans with substantial tax benefits. The preferential tax treatment of retirement plans reduces the employees current taxable income, and therefore makes it possible for employers to deliver to their employees a dollar of retirement income at a lower cost than a dollar of current wages. One of the rationales for the employment based characteristic of the private pension system is that it is believed that comparative advantages result from saving in employer sponsored plans, as opposed to personal savings arrangements. For example, participants should receive greater returns inside a plan than outside a plan because their accounts are professionally managed. Also, because the employer can benefit from economies of scale, administrative costs and other fees should be lower inside than outside a plan.

Although the sponsors of participant directed and employer directed plans enjoy the same tax benefits, participants in participant directed plans are not accorded the same non-tax advantages. In participant directed plans, participants, not the employer, make the investment decisions; consequently, they do not benefit from the expertise of financial professionals. Also, any advantages derived from economies of scale would diminish, if participants fail to make prudent investment decisions.

The self-help approach utilized by participant directed plans is inconsistent with ERISA's goal of increasing the retirement income security of plan participants. Presumably, the economic benefits enjoyed by employers are justifiable only if participants are, in fact, better off being covered by an employer sponsored arrangement than they otherwise would be. Therefore, in order to justify the cost of the private retirement system, and to achieve its objective of increased returns inside the plan, there should be residual fiduciary liability imposed on employers who sponsor participant directed plans.

To avoid residual liability for plan losses, employers who sponsor participant directed plans should be required to provide investment education sufficient to enable employees to make prudent investment decisions. In addition, in order to ensure that participants appreciate the significance of the risk of shortages when they fail to use less than optimum investment strategy, employers should be required to notify participants when their accounts are inadequately diversified, or otherwise exposed to greater than average risks of loss.

Employers who fail to comply with the education and notification requirement would be liable as ERISA fiduciaries for plan losses. Although determining actual loss in a defined contribution plan is not a straightforward calculation, the loss could be measured by either comparing the actual rate of return on the account to the average rate of return for Treasury bills, or to an average rate of return for a specified portfolio mix. After determining the loss, an excise tax should be imposed on the employer. The excise tax could be a flat rate tax designed to recoup an account holder's lost investment build-up. Alternatively, like the section 4971 tax for underfunding, the flat rate excise tax could be imposed at a rate high enough to both recoup asset losses, and discourage noncompliance. Another option is for the excise tax to be calculated on a case-by-case basis, using particular facts and circumstances to measure the exact loss. Regardless of how the tax is computed, however, under no circumstances should employers who completely insulate themselves from liability for the imprudent investment decisions made by plan participants enjoy the same level of tax benefits as sponsors who retain liability for the investment of plan assets.

II. A Minimum Education Standard

Sponsors of participant directed plans should be required to provide a minimum level of investment education and training because the success, or failure, of participant directed plans ultimately depends on the participant's ability to make prudent investment decisions.

In employer directed plans, a plan administrator, or an investment professional, typically controls the plan investments. These individuals are required to allocate investments in a manner that protects the accounts against inflation, sudden fluctuations, and unfavorable market conditions. In participant directed plans the same investment strategy should be used, but often is not, because employees generally do not have sufficient investment training to achieve this objective. Inexperienced participants generally fail to adequately diversify their retirement accounts, investing disproportionately in stable value funds.

The modern portfolio theory of investment explains that an adequately diversified portfolio should include an appropriate balance of stocks, bonds, and stable-valued funds. Furthermore, the professional guidelines for investment mangers prohibit them from investing more than 10% of a retirement plan's funds in a single asset. Recommendations and restrictions such as these exist because a balanced investment portfolio provides an appropriate relationship between risk and return. For example, a high concentration of stable-value, low-yield, instruments will generally produce insufficient income over a participant's working life to provide financial security at retirement. Therefore, an individual who disproportionately invests in low-yield instruments would have to save significantly greater amounts to be in the same position at retirement as participants who sufficiently diversify their investment portfolios. Similarly, an individual who overinvests in a single asset is excessively vulnerable to fluctuations in a particular market, and exposes her retirement savings to a greater risk of loss.

Inexperienced investors are not only less likely to adequately diversify their portfolios, but are also less likely to recognize the financial indicators on which trained professionals rely when deciding to transfer funds from one investment to another. Therefore, an untrained investor may fail to make changes when they are warranted, or in other situations may react too quickly. For example, in sudden market down-turns these individuals may sell high-risk, high-return investments too hastily, although professional investors generally believe that such investments perform best over the long-run. Thus, the success or failure of participant directed plans ultimately depends on the individual participant's ability to properly allocate plan assets. Consequently, there should be a minimum education requirement imposed on the plan sponsor.

Some employers voluntarily provide education for their employees to enable them to make prudent investment decisions; however, many employers choose not to provide such programs because they are costly. Moreover, under current law the provision of investment education could expose the employer to fiduciary liability for plan losses if the information is considered investment advice, and later proves to be incorrect.

If employers who sponsor defined contribution plans were required to provide a minimum level of investment education it would be more likely that participants would be able to make investment decisions consistent with professional guidelines. An education requirement would also enable participants to appreciate the future value of their expected retirement so that they could determine if they needed to supplement their expected retirement benefits with increased personal savings. Furthermore, an education requirement would also provide consistent standards for the type of investment information participants would receive from one employer to another.

A properly implemented minimum education requirement should mandate a variety of educational mediums. There is substantial evidence showing that printed communication generally is ineffective in aiding the investment education of plan participants, because employees either do not understand the written materials, or disregard them. Therefore, the requirement should specifically include a complement of written materials, seminars, and financial planning software, on retirement asset management. The education provided in connection with the minimum standard should not be generic. The education provided should be responsive to the investment needs of different groups within the workforce. For example, there should be age specific information that reflects the different investment strategies recommended for those nearing retirement, versus those who are not.

III. Insurance Protection for Defined Contribution Plans

Insurance protection comparable in amount and objective to the defined benefit plan insurance program should be available to defined contribution plan participants.

Another reason defined contribution plan participants are more likely to experience shortfalls in their retirement benefits is because the insurance program for retirement plans has a gap in its coverage. Defined benefit plans are insured by the Pension Benefit Guaranty Corporation, the (PBGC), against losses owing to plan failure. The PBGC insures a limited accrued retirement benefit in defined benefit plans which is phased in over a period of five years. The maximum insurable benefit is approximately $35,000 per year for an individual who retires at page 65. However, defined contribution plan participants receive no such protection.

Section 3(34) of ERISA specifically provides that PBGC protection is unavailable to individual account plans. This section defines individual account plans as plans in which the level of benefit for each employee fluctuates depending on the experience of the account. Because the retirement benefits in defined contribution plans are determined by the contributions and the investment performance of each separate account, defined contribution plans are excluded from coverage.

Although policymakers have been reluctant to insure investment experience as opposed to definite retirement benefits, the effects of poor investment performance in defined contribution plans and defined benefit plans, in reality, are very similar. Thus, the distinction between insuring investment performance in defined contribution plans, and insuring definitely determinable benefits in defined benefit plans is primarily based on perception. Moreover, because of the use of advanced funding methods in defined benefit plans, insuring a minimum investment return in retirement savings plans actually occurs under the existing defined benefit plan insurance program.

The funding of ongoing defined benefit plans is determined by the use of actuarial cost methods. Actuarial cost methods estimate plan costs and assign the costs to appropriate years. The present value of pension benefits and liabilities depends on the actuarial assumptions selected for interest, early retirement, turnover, and salary increases. Regardless of how carefully the actuarial assumptions are selected, advanced funding methods can only produce cost estimates, not actual costs. Therefore, typically a plan will either have a funding surplus or a funding deficiency, because any deviation in the assumptions when compared with actual plan experience will produce a shortfall, or a windfall.

When a defined benefit plan terminates with insufficient assets, the PBGC pays the plan's vested accrued benefits at the time of termination. In other words, the PBGC insures plan participants against shortfalls that arise from differences in the estimated funding cost and the actual cost of a defined benefit plan. Whether plan losses are due to an erroneous turnover assumption or an erroneous interest rate assumption, the PBGC is liable for the unfunded vested accrued benefits. Because the interest rate assumption typically reflects the long-term nature of the pension obligations, a change in the interest rate assumption affects the valuation results more than a change in any other actuarial assumption. Consequently, the accuracy of the interest rate assumption is especially critical in preventing shortfalls.

Even if all other assumptions are correct, when a plan experiences losses due to erroneous interest rate assumptions, a significant funding deficiency could result. In such cases, if the plan terminated, and the employer were unable to make an additional contribution, the PBGC would pay the unfunded vested accrued benefits up to the applicable limits. Effectively, when the PBGC pays any portion of the retirement benefits in plans in which all actuarial assumptions other than the interest rate assumption are correct, the PBGC insures a minimum investment return. Therefore, under existing pension law, participants in defined benefit plans are, in fact, insured against poor investment performance.

By comparison, there presently is no protection against less than average investment performance for participants in defined contribution plans. When shortfalls occur because of unfavorable market conditions, the participant alone bears the loss. The prevalence of defined contribution plans in today's market makes the failure to provide insurance protection to defined contribution plan participants a serious threat to retirement income security. Millions of plan participants now rely upon defined contribution plans as their primary retirement savings vehicles. Although providing insurance protection against unfavorable investment performance for defined contribution plans is a controversial subject, designing a defined contribution plan insurance program comparable in amount and objective to the existing defined benefit plan insurance program is a feasible concept.

In the article I wrote entitled *Rethinking the Risk of Defined Contribution Plans*, I proposed a risk-based, voluntary insurance program to insure defined contribution plan participants against the risk of earning less than average investment returns, over their working lives. Under the proposal, annual guaranteed rates of return would be determined by the performance of a hypothetical account, assumed to be invested according to a prescribed diversification formula. This insurance model is designed to protect the participant against the negative effects of severe market contractions over the participant's working life. Consequently, if the market took a sudden downturn immediately preceding a participant's retirement, the participant would be guaranteed at least an average return on her aggregate contributions over her working life, notwithstanding the actual account balance at retirement.

The proposed insurance model hinges on a diversification formula, which defines an acceptable range of complementary allocations with respect to both investment category, and risk classification. The diversification formula would be designed to approximate an average rate of return for an account invested in average risk investment instruments, over a participant's working life. For example, the safe harbor diversification allocation could be selected consistently with the recommendations of financial planning experts who advise individuals for a moderate return to place 60% of their investment assets in the stock of companies with moderate volatility, 25% in investment grade bonds, and 15% in stable value instruments. Additionally, the diversification formula would also limit the extent to which an insured account could be invested in a single asset.

The level of insurance protection and the cost of the insurance premium would depend on the degree to which the participant's allocation complied with the diversification formula. Using an established indexing system, a risk factor would be assigned to all allocations in order to compare their risk exposure to that of the prescribed diversification standard. In order for an account to be fully insurable at the regular premium rate, the participant's account could not be exposed to an investment risk greater than that of the prescribed diversification formula. Accounts having a risk factor greater than that of the prescribed diversification formula would not be in compliance with the diversification standard, and accordingly would not be insurable at the regular premium rate. Unlike the existing mandatory insurance program for defined benefit plans, the proposed insurance program would be voluntary. The voluntary characteristic of the proposal strikes a balance between individual choice and retirement income security. However, because the proposed insurance model is not mandatory, it would be unlikely that all defined contribution plan accounts would ever be protected.

Skeptics of defined contribution plan insurance will argue that extending insurance to defined contribution plans will intensify the financial troubles of the PBGC. This concern is valid, however, only if the defined contribution plan insurance program replicated, or expanded the existing insurance program for defined benefit plans. The proposed insurance model does neither. The proposed program is a completely new program, with a completely new structure. Furthermore, the proposed program makes adjustments for recent awareness of the design deficiencies in the defined benefit plan insurance program. For example, the premiums for the PBGC insurance program are not fully risk based, or economically derived. These characteristics have contributed to much of the financial difficulty that the PBGC has experienced. By comparison, the premiums for the proposed defined contribution plan insurance program are both risk based, and economically derived. Therefore, the insuring institution, economically, should be no better or worse off for establishing the program.

Others opponents will register concern that a defined contribution plan insurance program would increase federal exposure, possibly leading to a bailout similar to the one that resulted from the 1980's savings and loan crisis. This result is unlikely, however, because the 1980 bailout developed out of circumstances unique to the savings and loan industry. For example, because funds placed in savings and loan institutions are available to depositors upon demand, when news that the savings and loans were experiencing financial difficulties reached the public, many depositors immediately withdrew their funds. This reaction severely worsened the financial position of these institutions. In contrast, in qualified retirement savings arrangements early distributions generally are disallowed, unless specific events occur, such as early retirement, disability, or death. Thus, it would be unlikely that a single event would ever increase the volume of insured claims in a retirement insurance program as it did in the savings and loan crisis.

Finally, another argument that is likely to be made by those who oppose the concept of defined contribution plan insurance, is that it would cause employers, or individual participants, to expose their accounts to unreasonable investment risks. This concern expresses the moral hazard problem: those who are insured against certain risks have no incentive to use optimal care to avoid the risk.

Prior to the passage of ERISA, there were similar concerns that the adoption of defined benefit plan insurance would encourage employers to engage in risky investment practices. As a result, the pre-ERISA Committee determined that it was necessary to adopt safeguards to prevent this behavior. Accordingly, the committee imposed restrictions on the employer's ability to recover from the PBGC. These restrictions remain in effect today. In connection with defined contribution plan insurance it would be necessary to adopt similar safeguards. Furthermore, the defined contribution plan insurance proposal that I have described in my testimony solves this problem by using the diversification formula to limit the risk exposure of insured accounts.

Insuring defined contribution plans does in fact present difficult tradeoffs. However, many of the concerns regarding such a program are reactionary rather than substantive. As for the relatively few substantive concerns, the overwhelming need to amend ERISA to respond to the current pension climate would appear to offset any difficulties that these concerns present. Therefore, notwithstanding the complexity of implementing a defined contribution plan insurance program, serious consideration should be given to the concept of establishing an insurance program for defined contribution plans. Whether consideration is given to the model of insurance that I have described in my testimony, or another model, it is important that some attempt be made to establish an insurance program for defined contribution plan participants in order to meet the needs of future retirees.

Chairman THOMAS. Thank you, and I appreciate the testimony of all three of you.

Mr. Vanderhei, we heard earlier that actually the number of companies that participate is not that great, utilizing stock, but apparently those that do have quite a bit of involvement and the dollar amounts are quite significant. So it is the usual situation of probably very large companies.

Is there any data that gives you kind of a profile of companies that might participate, Mr. Schieber or Professor Jefferson, or does it really run the gamut of different types of companies, structure of companies, what they do?

Mr. VANDERHEI. When you say participate, do you mean offer company stock in the investment——

Chairman THOMAS. Offer company stock. Does there tend to be a pattern for the company that would do this?

Mr. VANDERHEI. We only have it broken down currently by plan size, which is in my written testimony. We have no ability to identify industry code or anything else in our database. I am sorry.

Chairman THOMAS. No, that is okay.

Mr. SCHIEBER One thing you should keep in mind, to the extent that this does tend to be concentrated among larger employers, many of these employers do have defined benefit plans. So when you are looking at the amount of company stock that a particular worker might have in his or her 401(k) portfolio, that may be a relatively small part of their total retirement portfolio.

One of the problems here is that not every employee holding company stock is necessarily exposed to the same kind of risk.

Chairman THOMAS. And it is not either/or, correct. And that is one of the problems we have got to get to, and that is, is there no average or profile? And, therefore, in passing legislation we have to be very sensitive to it.

One of the things that struck me, Mr. Vanderhei, on your Figure 2 was the actuarial difference between the male and female on the payout and the drops and the rest. Does that hold true, is that just the usual actuarial difference age-wise and payout-wise? You said you had additional figures that would be similar with different profiles in terms of losses and gains.

Mr. VANDERHEI. Right.

Chairman THOMAS. Does the differential of male-female maintain?

Mr. VANDERHEI. Much of that is due to not only a difference in age-specific and gender-specific participation rates in the 401(k) system, but also their contribution rates and when they make the contributions during their working careers.

When I said I could run under different assumptions, I was basically referring to different investment rates of return.

Chairman THOMAS. Right, but you still get that actuarial difference.

Mr. VANDERHEI. Yes, that is correct.

Chairman THOMAS. It will stick with every profile.

Mr. VANDERHEI. Yes.

Chairman THOMAS. Mr. Jefferson, you said that there is no real difference between the defined contribution savings or someone doing it on their own. But do you really believe that there would be 55 million Americans with $2.5 trillion in savings if they didn't have this structure? Isn't one of the problems that Americans just don't save on their own?

Ms. JEFFERSON. Well, first, to clarify, I indicated that insuring a guaranteed amount in defined contribution plans is effectively no different, and no more difficult than insuring, as we do now, a guaranteed return in defined benefit plans.

Chairman THOMAS. Well, that is a question I want to ask each of the other individuals. Do you believe there really would be no differences between insuring a defined benefit and a defined contribution plan?

Mr. SCHIEBER There is tremendous——

Ms. JEFFERSON. In——

Chairman THOMAS. Well, I know your position. I want to see if they agree with you or disagree.

Mr. SCHIEBER Well, I strongly disagree. In the case of the insurance that is provided through the PBGC, those plans are insured in the case where an employer goes bankrupt and can no longer sustain the plan.

Now, because of the financial interest that the PBGC has in providing that kind of—the government has in providing that kind of insurance, there are multiple regulations that require that these plans be funded, that they be valued on a regular basis. There is a tremendous difference between these plans, no matter how you look at it.

Mr. VANDERHEI. I would just add to what Syl mentioned, that you also with the PBGC defined benefit insurance system have a buffer from an ongoing employer. Just because you have adverse investment experience with a defined benefit does not necessarily present a claim to the government agency until such time as there is a bankruptcy on the part of the sponsor. So to compare those two is to look at completely different probabilities.

Mr. SCHIEBER. And, in fact, if the employer realizes adverse returns on the account, they have to actually accelerate their contributions to get themselves back up to the funding levels, or else they have to pay higher insurance premiums.

Chairman THOMAS. And, conversely, if they have been paying more in, there is now a way in which they can back off of the percentage that they are paying.

Mr. SCHIEBER. Correct.

Ms. JEFFERSON. I would like to follow up.

Chairman THOMAS. You should.

Ms. JEFFERSON. The comparison I made was for the limited purpose of contrasting the guarantee of the interest rate. Certainly the plans are fundamentally different, and I would not take the position that the plans were not different in other respects.

In the article I wrote, I describe in greater detail, the structure of the proposed insurance program. I explain that in order to preserve the integrity of the program it would be necessary to put restrictions on the payment of defined contribution plan insurance, just as there are restrictions now placed on defined benefit plan insurance.

Chairman THOMAS. I guess part of my problem is that I understand the ability to create an insurance structure, even a government-underwritten one, on a bankruptcy of a company and its promised pension plan versus guaranteeing some return on individual investments or what is the appropriate plan, unless someone went belly up, like a bankruptcy on an individual basis or a zero gain over a period of time. That gets me back then to the "you can't fail" scenario in which why wouldn't you be aggressive and roll the dice.

So I do think that that is something we are going to have to look at. I appreciate—and I have not seen your article yet, but I read your material, and we are going to have to examine your options a little more closely.

Ms. JEFFERSON. I would like to respond to the point that you raise about moral hazard: meaning those who are insured against certain risks have no incentive to use optimum care to avoid the insured risk. This same concern was present in 1974 when the insurance program was established for defined benefit plans. People feared that insurance would encourage abusive practices regarding risk exposure by allowing employers to promise excessively large insurance benefits, and this is why there are restrictions on the amount and the conditions under which the employer can recover from the PBGC.

The proposed insurance program for defined contribution plans addresses the moral hazard problem by using a diversification formula which would require an insured participant to invest according to a prescribed standard.

Chairman THOMAS. Except, again, you are dictating a profile to address one issue while someone may want to invest to address a different issue, and that is an enhancement of their retirement at some risk.

Ms. JEFFERSON. Well, actually not. The proposal I make is a voluntary program. Therefore, if a participant did not want to participate, they would not be required to do so. That is one of the distinctions between the existing defined benefit insurance model and the one that I propose for defined contribution plans.

Chairman THOMAS. And I will tell you, Professor, if you have someone who chooses to be covered and someone who chooses not to be, folks will be back here very quickly to make sure that those who took that voluntary risk are covered, anyway. In fact, we have Members of the Committee who are already advocating that.

Let me ask you finally in terms of the President's plans. Obviously, Professor Jefferson, you have some other concerns, but you underscored education, and I think that is one thing we are all in agreement, that we can't get too much education to consumers, whether it is health care or retirement. But with the exception, for example, of the colloquy between Mr. Pomeroy and the Administration in which they agreed that some of the points that Mr. Pomeroy made in another Committee were valid points, on the whole does the President's plan seem to be pretty much useful in responding to current concerns? Or are there some particular holes in it from your perspective that need to be addressed? Maybe we would just start with Mr. Vanderhei and move across the panel. Pretty much okay or are there particulars that you would like to see beefed up?

Mr. VANDERHEI. I would certainly say it depends on what your objective is. If your objective is to try to continue a relatively successful system, it seems to not only respond to the concerns about the lack of diversification after a certain period of time, but also—and this is very important—keeps incentives there for the employers to make matching contributions.

In many studies that both Syl and I have done independently in the past, the primary motivating feature for employees to make contributions is the employer match. You take that away, you are not just taking away the employer money going into the 401(k) accounts; you are also probably taking away a large share of the employee money that follows it.

Chairman THOMAS. Mr. Schieber.

Mr. SCHIEBER You know, it leaves considerable flexibility in these plans. To the extent that you have employers who are doing a good job with their operations and with their workers, giving the workers some flexibility to continue to invest where they want to invest, without restricting them to the extent that maybe some have been restricted in the past, calls for additional education, which I believe is valuable. It addresses the blackout rule. There might be other ways to address it, but at least it addresses it—it gives a common interest, as I think someone here characterized earlier, the top floor and the shop floor.

So I think it goes a long way in terms of correcting problems that are perceived coming out of the recent experience.

Chairman THOMAS. Professor Jefferson?

Ms. JEFFERSON. One of the concerns I have is that it does not guarantee a minimum retirement benefit. I believe it is important to have a minimum guaranteed benefit simply because without it, as we see with the Enron employees, people who have been saving in a tax-subsidized retirement arrangement, may end up having nothing. So, that would be my primary concern with the proposal.

Chairman THOMAS. Again, I want to thank you for the work you have done in this area, and as more and more people become aware of the downside—everyone was aware of the upside. Our job is to protect on the downside without taking away the opportunity on the upside. So thank you.

Does the gentleman from New York wish to inquire?

Mr. RANGEL. Yes, thank you.

Professor Jefferson, Mr. Schieber had indicated, as it relates to this concept of guarantee a part of the employee's pension, that he cannot think of any single policy change that would have the potential to so radically alter the landscape of our retirement system in an adverse way. So I think he has made up his mind about providing guaranteed returns in defined contributions.

How would you address this statement that strongly worded?

Ms. JEFFERSON. It is my position that it does not radically change the playingfield; that indeed that was the purpose of making the comparison between the defined benefit plan and the defined contribution plan.

In fact, in some situations under the existing insurance program, we effectively do insure an investment return. As I explained earlier, if all actuarial assumptions are correct in a defined benefit plan funding schedule, except for the interest rate assumption, then to the extent that the PBGC at any point provides payment for the plan's benefits, there would be a guarantee of an investment return at some level.

So it is my position that insuring a minimum return in defined contribution plans is not as radically different as one might think. It is really a problem of perception rather than reality.

Mr. RANGEL. Thank you.

Mr. Schieber, in the Enron type of situation where an employee gets wiped out because of misinformation, do you believe that the Federal Government has any responsibility at all to make the employee whole, protected in whole or in part?

Mr. SCHIEBER. I think the government has responsibility here, but I believe it has responsibility before the horse gets out of the barn. And——

Mr. RANGEL. Let me try to rephrase the question, because that horse is out of the barn and the person now is left without a pension fund. As one of the Members has stated, many corporations' horses get out of the barn, and we in Congress are called upon to give some assistance after the horse is out of the barn.

Now, this employee's pension is out of the account, and I am just asking: Do you think we have any responsibility to provide any relief at all to this type of employee?

Mr. SCHIEBER. These employees were investing their money largely at their own direction. We do not insure investors generally in this society——

Mr. RANGEL. Why is it so difficult to say you play the game, you take your risk, you lose, you lose. That is what—I think that is where you have got to end up.

Mr. SCHIEBER. And that happens every day in our economy. It happens with jobs. It happens with——

Mr. RANGEL. I am not arguing with you, and so I am not saying that you have an indefensible position. It is just I want to take a clearer look as to how you look at pensions and your government's role in protecting the investor. That is all.

Mr. SCHIEBER. I think the government has a very important role in protecting investors. We learned that coming out of the Great Depression with the establishment of the SEC and many of the rules. I think that there have been breakdowns in disclosure, in accounting——

Mr. RANGEL. What about the Social Security system? Do you think we should move toward privatization of the——

Mr. SCHIEBER. I have sat in front of this Committee and suggested that we should have some individual account reform on more than one occasion in the past. Yes, I do.

Mr. RANGEL. So you really believe that investors should have more freedom in making his or her determination as to where they want to place their money, and if it is high risk, that should be their choice, and if they make mistakes, then the government should not be there for them.

Mr. SCHIEBER. What I have advocated in terms of Social Security would be more restrictive than what I think should operate with supplemental plans. I have not advocated the same sorts of investment freedom with Social Security accounts that I think employees should enjoy with their 401(k) money. Their 401(k) money has gone into those accounts because they made a decision of their own to put their money, to defer consumption, into these accounts.

If you want to go back, you can go back to the period during the early 1980s when these plans first evolved. And at that juncture, most of the money was invested by the employer on a pooled basis. Most employees didn't like that kind of investment of their retirement assets because employers were investing that money along the lines being advocated here, in a relatively risk-free form of investment vehicle. And the employees wanted to have greater opportunities to realize returns from the financial markets. They demanded it, and that was largely why employers went in the direction they went in restructuring their plans.

Maybe you can stand in front of the tide and stop it, but there were massive numbers of workers who want this system to work largely the way that it does.

Mr. McCRERY. [Presiding.] Thank you. I will just point out before I call on Mr. Portman that I think you were on the right track for a second, Mr. Schieber, pointing out that the government does a number of things to protect investors. We do regulate the stock market, individual stocks. We also regulate the accounting profession. We do a number of things to try to protect investors.

But the government can't protect investors from criminal activity, from wrongdoing, just as, say, a wealthy lawyer gets taken by somebody with a bogus investment deal, the government doesn't insure that. We don't go to that lawyer and say here is your money back, or a doctor who invests his money——

Mr. RANGEL. If the Chairman would yield?

Mr. MCCRERY. I would be glad to.

Mr. RANGEL. What we are doing, we are partners in providing incentives for the employee to participate in these plans and providing incentives for the employer to do it, and so this Committee through the tax laws, we are partners in this. This is not just some lawyer out there. We are encouraging, it is public policy, and I would believe——

Mr. MCCRERY. I would hope everyone would agree that it is good public policy.

Mr. RANGEL. And I would like to believe if my government was encouraging me to make this type of investment, that my government would give me some protection as well from the free market, allowing the free market to work its will. But I know that I disagree with you and Mr. Schieber, and it wouldn't surprise me if ultimately you would like to see us get out of the Social Security business altogether, you know, which is——

Mr. MCCRERY. Is it Schieber——

Mr. SCHIEBER. That is not anything I have ever advocated.

Mr. RANGEL. Some of my colleagues in the Congress thought it was a bad idea when it started, it is a worse idea now. And so——

Mr. SCHIEBER. Social Security?

Mr. RANGEL. Yes.

Mr. SCHIEBER. Congress thinks it is a bad idea?

Mr. RANGEL. I am not saying that Mr. Armey is the Congress, but he certainly has spoken that way many times, you know. Listen, he is leaving, but a lot of people thought it was socialistic, and that the best government is no government. I think even our Chairman——

Mr. SCHIEBER. I would be happy to come back and talk at length about Social Security.

Mr. MCCRERY. I think we have gotten off the track. So to get us back on track, I am going to call on Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and I thank the witnesses for their testimony today. This area, as you know, on the defined contribution side is full of regulations and rules, and this Committee has spent a lot of time looking at those and tried to make sense of them. The top-heavy rules would be one; the nondiscrimination testing would be another, all kinds of fiduciary responsibilities. So we are partners, and there is an active role by the Federal Government. It is a tremendous subsidy. In fact, I count it to be probably the largest single subsidy in the Tax Code now, retirement generally.

But the question is how do we build on the success of the defined contribution wave. I would say it is a wave, not a tide.

Mr. Rangel is a pretty powerful guy. I don't know if he can stop the wave, and there is a good reason for it.

I really appreciate EBRI's work. We have worked with them closely, and they always provide good, objective counsel. This one figure, if we told everybody they had to limit investments at 5 percent, they couldn't be below that for people born my age or after, there would be a 25- to 30-percent reduction in what they would get. And that is EBRI. And EBRI is not partisan, and EBRI is very careful about the statistics that they rely on. That is the wave. That is the tide. I mean, there is a reason people feel this way. And all those people are now watching CNBC and those 42 million-plus investors in 401(k)s and others in 403(b)s and 457s and so on. A lot of them know what they are doing. And I talk to a lot of them, and it is true, diversification makes sense for retirement. On the other hand, if you are 25 years old and you want to take a little risk and you are watching the market, should we say to that person you can't invest more than 20 percent in a particular stock?

I represent Cincinnati. We have the Procter & Gamble company there, and most of the stock in that plant is so-called non-elective. It is not even a match. They just provide it. They provided it to my dad when he worked there in the 1950s. I have still got some. They are very happy with that, and they know what they are doing. And they have done quite well.

There are lots of other examples like that, but another statistic that frightens me is that 48 percent of 401(k) participants have more than 20 percent of their plans in company stock. So you are going to tell half of the people in 401(k)s you can't do what you want to do.

Now, I am all for retirement education, and I think that is the next big challenge. I think the bill last year was a good bill. I agree with Mr. Schieber. We worked long and hard on it. But I think we frankly have more to do in education. And I think Professor Jefferson makes a good point there. The big challenge, as I see it, is being sure that people have access to investment advice. Companies are very loath to provide it, as you know, because they worry about liability. And it is tough to provide it without weighing some very subjective factors. But we have to break through that, and that is why some of us are willing to take a risk on the investment advice bill. I agree with the colloquy that Mr. Pomeroy had with Mr. Boehner as well, and maybe there are some other things that we can do.

Let me ask about one piece of our bill that Ben Cardin and I have introduced this year in response to the Enron situation and trying to get at this diversification and education. We have a pretax investment advice piece. I don't know if you have seen it, but it would be like a cafeteria plan. You could use pre-tax dollars. You could take a payroll deduction in order to get advice yourself. The employer wouldn't be telling you who to use. It wouldn't be somebody coming in that had anything to do with your plan. It would be you getting 300 or 400 bucks to go out and get advice.

I don't know how many people would want to set aside money for that, but I think there would be some. What do you think about that idea? Any of you.

Ms. JEFFERSON. I believe that is an excellent idea, and I would support it. I think that self-help should be available and encouraged. However, I don't believe that this approach is sufficient, for individuals who may not recognize that they need financial training or who may not be able to afford it. Therefore, I would be in favor such a program, but not as a substitute for a mandatory education requirment.

Mr. PORTMAN. Any other thoughts on that?

Mr. SCHIEBER. I would support it also. You may also want to consider letting plan sponsors use employee assets during the blackout periods to minimize the blackout periods. We were listening earlier that when the sponsors are fiduciaries here, they are supposed to have the participants' interests as their primary concern. If you look at how the plan sponsors manage their own money, they wouldn't shut down their accounts receivable systems for 2 weeks or a month.

But having a transition accounting or administration system that runs in parallel over a time and allows instantaneous shift over costs money. And some employers simply can't afford it, but they could if they could tap some of the plan assets—and it should not take very much money. It is a small marginal cost relative to the plan, but it would allow people to protect themselves.

Mr. PORTMAN. To tap their assets during a blackout period.

Mr. SCHIEBER. I am sorry?

Mr. PORTMAN. The employees would be able to access their assets during the blackout period.

Mr. SCHIEBER. So plan money could actually be used to run systems for 2 weeks in parallel, or some period, and then have an instantaneous switch-over rather than having this blackout period that runs for a couple of weeks.

Businesspeople themselves don't shut down their financial operations for 2 weeks because they are changing their accounting systems.

Mr. PORTMAN. As you know, one of the proposals in the President's plan is to encourage shorter blackouts by saying during a blackout you can't trade in company stock, even outside of a qualified plan, which is an interesting concept, and one that we don't have time to get into because the red light is on. Mr. Rangel has a proposal on that as well. His proposal maintains the jurisdiction of the Ways and Means Committee, which we all like, provides for an excise tax during that period, should there be trades. But both of those would be incentives to reduce that time. I think that makes sense.

Professor Jefferson—I appreciate the Chairman's indulgence—just quickly, on your idea of a voluntary insurance. I listened to you, and I am just not sure how it would work. And I guess when I think through what you would like to do, wouldn't it be simpler just to say to an employer you have got to invest in GICs or you have to invest in treasuries, rather than setting up an elaborate insurance system. You simply say, as some would say for Social Security private accounts, you can't go into your brother-in-law's real estate or even some would say even into equities, you have to stay in much safer investments, lower risk, lower yield.

Wouldn't that be a simpler way to go about what you are trying to do?

Ms. JEFFERSON. It may be simpler, but I think that what happens with the voluntary aspect of my proposal is that it balances. On the one hand, it does allow the participant to make a choice about what they want to invest in. But, on the other hand, it provides some type of guarantee.

So I think that is does strike a balance differently than requiring them to——

Mr. PORTMAN. Would this simply be a new Federal subsidized plan, in other words, a new qualified plan that employers would have the option to offer or not offer, much as 401(k)s are. There is no requirement, as you know, to provide a defined contribution or a defined benefit plan. You wouldn't change that?

Ms. JEFFERSON. I am sorry. Would you repeat the question please?

Mr. PORTMAN. You wouldn't require employers then to provide this? It would be voluntary on the part of employers as well?

Ms. JEFFERSON. That is correct. It would be voluntary. And, also, one of the distinctions between this model and what is available for defined benefit plans is that the premiums would be risk-based and economically derived. So what that means is that the insuring institution should be economically no better off or worse off for having established the program.

So, as I said, one of the major differences between the PBGC insurance and what I am proposing is that it would not be a situation where there would be a flat premium rate. As a result, the premium rate would not be a flat rate but would be based on the risk exposure of the account.

Mr. PORTMAN. So the market would decide what the rate is. It is a different kind of insurance, obviously, because in a sense PBGC doesn't insure the plan as much as the company.

Ms. JEFFERSON. That is exactly right.

Mr. PORTMAN. In other words, PBGC doesn't guarantee the return. The company does.

Ms. JEFFERSON. But the end result would be the same, there would be some guarantee for the participant. And I think that is where there would is similarity. But you are correct the insurance and the triggering events for payment would be structured differently because the plans are different.

Mr. PORTMAN. I guess my time is up, and I won't take any more time of the Committee. But, again, I really appreciate the input, and particularly the facts. We just need to get more of the facts here. And I think when you look at the 401(k) experience over the last 20 years, it has been remarkably successful. We have tinkered with it recently to try to make it even more successful and, frankly, expand it to smaller businesses, which is the big challenge. And I think the next big challenge is to give people more security after Enron and to provide more education and advice. I hope you will help us do that. Thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman.

First of all, I want to begin by commending Professor Jefferson. One of your former students, Alane Allman, is staffing me on pension and Social Security issues for my Ways and Means assignment, and she is doing an absolutely superb job, so she must have been well trained somewhere. I give you part of the credit. You were her tax professor.

Ms. JEFFERSON. Thank you.

Mr. POMEROY. You know what? I think as we talk about the wonderful success of 401(k)s—and they certainly have played a very important role in people preparing for retirement—it would do well for us to look at what we have lost by way of retirement security as we move from a defined benefit to a defined contribution format. We ought to reflect on that a little.

Now, that doesn't really get to Enron issues and the fix du jour. It gets to more of the structure of U.S. retirement programs and whether or not we ought to rethink or at least try to revitalize pensions as a lower-risk, annuitized, lifetime stream of income in retirement that had a lot going for it.

Mr. Vanderhei, I know that EBRI has done some research in this area. Can you tell us the average balance in a 401(k) plan for a worker in——

Mr. VANDERHEI. We don't have year-end 2001 data, but it is just shy of $50,000. But I would like to make a very important caveat on that. That is with the most recent employer. As you know, many employees will go through their careers with several different employers, and when they change jobs, they will either leave that money with the previous employer, roll it over to the new employer, perhaps cash it out, or as is being done more and more often today, roll it over to an IRA.

In all the simulations we have done, the IRA rollover market in the future swamps defined contribution plans. It swamps defined benefit plans. So when you look at the $50,000, I would just caution, don't look at that and say that is all 401(k)s are contributing to retirement security, because 401(k)s are generating those IRA rollovers that will be a very, very large part of the future retirement income security for those individuals.

Mr. POMEROY. I think it is important to have the full context of whether or not these accounts show alarmingly insufficient balances or somewhere near adequate balances. Do you have any idea what kind of annuity payment you could buy for 50 grand at the age of 65?

Mr. VANDERHEI. Well, if you want to look at age 65, then I would say forget the $50,000 I just told you and take a look at what we have for people in their 60s that have basically been with an employer for their entire career. The only reason I am doing that is it prevents the IRA leakages that I just referred to.

I could check the exact figure for you, but I believe it is approximately $200,000 that we came up with for year-end 2000.

Mr. POMEROY. I have the following concerns, and not just about asset diversification, whether or not there is sufficient savings occurring in the 401(k). And then one aspect that we are really going to begin to wrestle with, but haven't yet is that upon retirement are these assets matched to an average life span? Are they being dissipated unduly quickly?

Syl, have you done any—Mr. Schieber, have you——

Mr. SCHIEBER. First of all, you and I would both like to go back to the defined benefit world, and we would like to see people reach retirement age with a 30-year career under their belt at that last employer, and then convert their—get an annuity and live happily ever after and go fishing as frequently as they could and what have you.

The world isn't built that way, and it is a shame, but it is just not. The problem is workers move around, and even the ones that are participating in the defined benefit plans today, when they get to the end of their career, many of them haven't had 20 years or 30 years in that plan. It is a relatively short period.

Many of them work their first 10 or 15 years under one of those plans and go somewhere else, and the benefit they get out of them isn't all that generous.

There have been some market forces that have pushed people in this direction.

Mr. POMEROY. There was some horrific data about leakage at the time of change. Is that getting any better? It was about—a cashed-out plan, something like two-thirds of them weren't being——

Mr. SCHIEBER. But it is the small accounts that are leaking. The big accounts aren't. You know, young people turn over a lot more than older people. You know, until you are 25 or 30, in many cases you don't settle down. There are a couple of professors at Dartmouth who have looked at this issue, Jonathan Skinner and Andrew Samwick. And they have simulated workers' participating in defined benefit and defined contribution plans over a whole career, and they have taken account of job change. They have taken account of the pattern of leakage that goes on. And their conclusion is that the defined contribution plans are doing as good a job if not a better job than the defined benefit plans because of the way they work and because of mobility within the work force.

You know, it would be nice to get back to the good old days, but I am afraid we are kind of caught with what we——

Mr. POMEROY. Actually, we can't turn the clock back, but I am thinking that maybe looking at—instead of just recognizing worker choice and freedom relative to retirement funds as the ultimate objective of a worker's retirement account, I believe retirement income security is the ultimate objective and helping the worker manage risk, you know, asset accumulation risk, investment risk, and asset drawdown risk——

Mr. SCHIEBER. Don't forget longevity.

Mr. POMEROY. Right.

Mr. SCHIEBER. You are right. One of the problems, though, is this word "retirement." We designed our system around what we thought of the world back in the 1930s, and a lot of things have happened since the 1930s, but we have hung on to this idea of retirement set back then. And, if anything, we made retirement a bit more generous since then. But the realities of our demographics are changing on us in a way that demonstrates a real reluctance on the part of people who have to pay for these programs to continue to insure longevity. Longevity has really stretched out since the mid-1930s, but we still think of retiring at 65, or maybe even a little bit earlier. We have really stretched out the retirement period. But we still want to get the old benefit level.

Now, if you want to get that old benefit level for a longer period of time, somebody needs to put a lot more money in the pot. And we seem to be extremely reluctant to do that. We are reluctant to do that in Social Security. We are reluctant to do that in our employer pensions. And I think that is the nub, and that is what is really pushing, I think in many cases, folks to go to these defined contribution plans. They are putting the longevity risk on the workers.

Mr. POMEROY. I am very interested in kind of hybrid arrangements whereby we might be able to bring more risk management for the worker into the defined contribution—or DB proposal, some of these other things under discussion.

Professor, I want you to speak—and the Chairman has been very lenient with my time. Each of you have contributed so much to this topic. We could really go on at great length, and I want to salute the professional achievements each of you have made in this area. Professor?

Ms. JEFFERSON. I think that the points that you make are very good ones. There are actually two distinct problems. There is one problem with accumulating enough assets, and then there is another problem with making sure the assets are used for retirement.

Studies show that leakage is related not only to age but also to income. Therefore, low-income individuals who receive lump sum distributions before retirement age, are less likely to roll them over into other retirement savings arrangements. So the degree to which there is a leakage problem varies within the population of plan participants relate to age and income.

Mr. POMEROY. I am also interested in ways we encourage more annuitization of the lump sum at time of retirement, but there are too many issues to get into. Mr. Chairman, thank you for your indulgence.

Mr. MCCRERY. You are quite welcome, Mr. Pomeroy, and thank you all very much for your testimony and your patience today. We appreciate it and look forward to seeing you again.

The hearing is adjourned.

[Whereupon, at 5:27 p.m., the hearing was adjourned.]

[Question submitted from Mr. McInnis to Mr. Weinberger, and his response follows:]

Question: I would ask that the Treasury Department review and comment on the attached proposal, designed to better enable people to save for retirement. This proposed language would extend the current tax-free exchange treatment under IRC section 1035 to situations where a taxpayer consolidates one existing annuity into another existing annuity, for two new annuities, or may even take two existing annuities and exchange them for one new annuity—without triggering recognition of income or tax. The policy behind IRC section 1035 is to allow taxpayers the flexibility to shift their annuity savings to the best vehicle, with better rates or terms. That policy is also served with my proposal by allowing taxpayers the flexibility to consolidate two existing annuities into one already existing annuity. My proposal would deem such a consolidation of annuities to be an exchange, and includes language to prevent abuse or "leakage" of funds.

Given today's hearing on retirement issues, I would ask the Treasury Department's position regarding the attached proposal. My proposed language is a very minor change to IRC section 1035. It is my thought that the situation addressed by this proposal was simply not foreseen when IRC section 1035 was drafted. There is ample evidence that these annuities are used for retirement savings. A 1999 Gallop survey found that 81% of all people who purchased non-qualified annuities, and 94% of people under age 64, did so for retirement income. Given the focus of today's hearing, I would ask the Treasury Department to comment on this proposal to allow appropriate flexibility for taxpayers who use these annuities for retirement income.

I look forward to your response and continuing this dialog on how to encourage saving for retirement.

AMENDMENT OFFERED BY MR. MCINNIS

At the appropriate place in the bill insert the following new section:

SEC. ______. REINVESTMENT OF SURRENDERED ANNUITY PROCEEDS INTO CERTAIN EXISTING ANNUITY CONTRACTS TREATED AS AN EXCHANGE.

(a) IN GENERAL.—Section 1035 (relating to certain exchanges of insurance policies) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) REINVESTMENT OF SURRENDERED ANNUITY PROCEEDS INTO EXISTING ANNUITY CONTRACT TREATED AS AN EXCHANGE.—A transaction shall not fail to be treated as an exchange for purposes of subsection (a)(3) by reason of the fact that the proceeds of the surrendered annuity contract are invested in an existing annuity contract if——

"(1) the transaction would be treated as an exchange under this section were the surrendered annuity contract and the existing annuity contract surrendered in exchange for a new annuity contract having the same obligee and insured as the existing annuity contract, and

"(2) such proceeds are received directly by the issuer of the existing annuity contract from the issuer of the surrendered annuity contract."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contracts surrendered after the date of the enactment of this Act.

Answer: The Treasury Department believes that transactions involving the consolidation of annuity contracts are tax-free under current law section 1035. We are working with the IRS to issue guidance in the near future that will clarify this position.

Statement of Wayne Moore, American Prepaid Legal Services Institute, Chicago, Illinois

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 for 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, as Chairman Thomas noted in calling this hearing, is highly mobile, 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.

Representative Dave Camp's bill, H.R. 1434, 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 H.R. 1434 as part of any retirement security package to protect millions of working Americans' retirement funds.

Statement of the Industry Council for Tangible Assets, Inc., Annapolis, Maryland

S. 1405 ADDS NEEDED DIVERSITY & SECURITY TO RETIREMENT PLANS

History

While coin investing is certainly not unique to the United States, the market for rare US coins is the most highly developed coin market in the world. From 1795—1933 the US produced precious metals coinage for use in commerce. Twice during the US' two-hundred-year history, precious metals coins were recalled and melted by the government. These meltdowns helped transform US coinage from common monetary units into numismatic investments.

It is generally accepted that upwards of 95% of original mintages were lost due to mishandling or melting. The small surviving population of coins forms the backbone of the investment market for rare US coins.

Prior to 1981, *all* rare coins were qualified investments for individually-directed retirement accounts. In fact, rare coins *remain* as qualified investments today in certain corporate pension plans. The Economic Recovery Tax Act of 1981 eliminated the eligibility of rare coins for IRAs by adding Section 408(m) to the USC. Section 408(m) created an arbitrary category of "collectibles" which suddenly were no longer eligible investments. Regrettably, in 1981, the precious metals/rare coin industry had no trade association to voice objections, so this provision was enacted without opposition or benefit of comment.

The Industry Council for Tangible Assets, Inc. (ICTA) was formed in 1983 as a direct result of the 1981 legislation. Had ICTA existed in 1981, we believe that the organization could have easily demonstrated how the inclusion of precious metals as collectibles was clearly a mistake. For example, in his testimony before the Senate Finance Subcommittee on Savings, Pensions and Investment Policy, the then Assistant Secretary of the Treasury for Tax Policy, John E. Chapoton, lumped gold and silver into a collectibles category of "luxury items" that also included jewelry. Clearly, for centuries the US Federal Government has disagreed with this characterization insofar as it is precisely those products that are stored in the government's Fort Knox facility. Indeed finally, in the Taxpayer Relief Act of 1997, we did prevail and were successful in having precious metals (gold, silver, platinum, and palladium bars and coins) restored as qualified IRA investments.

It is interesting to note that Mr. Chapoton concedes the investment value of collectibles. However, once again, Mr. Chapoton applied certain collectibles criteria to rare coins and precious metals that were **not** appropriate. In fact, he often cited examples of the uses of jewelry and silverware as though they applied to rare coins and precious metals. (His arguments were similar to stating that, while cotton may be an essential ingredient in the manufacture of clothing fabric, disposable cotton balls, and currency banknotes, that does not mean that banknotes are the same as cotton balls.) The testimony relating to the consumption aspect (for example, a painting or antique rug may be enjoyed for its original intended function in addition to its investment potential) is especially irrelevant, since a coin's original function is to be spent—clearly not something the owner of a rare $20 gold coin now worth $500 would do. A bill pending in the US Congress, S.1405, would correct this situation and restore certain coins as qualified IRA investments

Expanded Safeguards

Beginning in 1986, the market in rare coins became even more viable for investors with the creation of nationally-recognized, independent certification/grading services. These companies do not buy or sell rare coin products. They are independent third party service companies whose sole function is to certify authenticity, determine grade, and then encapsulate each rare coin item. Each coin is sonically sealed in a hard plastic holder with the appropriate certification and bar coding information sealed within, which creates a unique, trackable item. This encapsulation serves also to preserve the coin in the same condition as when it was certified.

These companies employ staffs of full-time professional graders (numismatists) who examine each coin for authenticity and grade them according to established standards. Certified coins (as the resulting product is known) are backed by a strong guarantee from the service, which provides for economic remuneration in the event of a value-affecting error.

Unlike most other tangible assets, certified coins have high liquidity that is provided via two independent electronic trading networks—the Certified Coin Exchange (CCE) and Certified CoinNet. These networks are independent of each other and have no financial interest in the rare coin market beyond the service they provide. They are solely trading/information services.

Encapsulated coins now enjoy a sight-unseen market via these exchanges. These electronic trading networks function very much the same as NASDAQ with a series of published "bid" and "ask" prices and last trades. The two networks offer virtually immediate, on-line access to the live coin exchanges. The buys and sells are enforceable prices that must be honored as posted until updated. Submission to binding arbitration, although rarely necessary, is a condition of exchange membership. Just as investors in financial paper assets access the marketplace via their stockbroker, investors in rare coins access the on-line market via their member coin dealer(s). Trades are entered on these electronic networks in the same manner as trades are entered on NASDAQ, with confirmation provided by the trading exchange. These transactions are binding upon the parties.

Why Rare Coins Provide Needed Diversity in Investment Portfolios

Most brokerage firms and investment advisors recommend that persons saving for retirement diversify their investment portfolios to include some percentage of tangible assets that are negatively correlated to financial (paper) assets. Tangible assets tend to increase in value when stocks, bonds and other financial assets are experiencing a downward or uncertain trend. It is important that investors have both tangible asset options—precious metals *and* rare coins, just as they have the option of stocks and/or bonds.

The value of precious metals products fluctuates in direct proportion to the changes in price for each metal (gold, silver, platinum and palladium) on the commodity exchanges. The rare coin market is often *related* to the precious metals markets; however, rare coins have the added factor of scarcity, which adds to the stability of the market. For instance, a US $20 gold coin contains .9675 troy ounces of gold (almost a full ounce.) While the bullion-traded gold one-ounce American Eagle coin's price will fluctuate daily in accordance with the spot gold price, the US $20 will resist downward pricing since its value is in both its precious metals (intrinsic) content and its scarcity factor. To illustrate, today, with the gold spot price at $292, a one-ounce gold American Eagle bullion coin ($50 face value) retails for $303.50. The minimum investment grade US $20 face value gold coin (.9675 ounces of gold) retails for $424. The American Eagle gold coin has a higher face value and a slightly higher gold content, yet the value of the US $20 rare coin is $120 greater. While even "blue chip" stocks can become worthless (Eastern Airlines, for example), precious metals and rare coins can never be worth less than the higher of their intrinsic or legal tender face values.

What's Wrong With the Current Law

An independent study* prepared for the Joint Committee on Taxation found that the inclusion of rare coins and precious metals in a diversified portfolio of stocks and bonds increased the portfolio's overall return while reducing the overall risk of that portfolio. In fact, rare coins remain a qualified investment product for corporate pension plans. The average American investor should not be penalized for not having that particular tax-advantaged program available to him/her, and it would be only equitable to permit such investment options for those individually-directed retirement accounts. Removing current restrictions would allow small investors, whose total investment program (or most of it) consists of their IRAs or other self-directed accounts, to select from the same investment options currently available to more affluent citizens.

In addition, the current law creates the inequitable result that occurs when an individual leaves one job and its related pension and profit-sharing plan. When employees leave or are terminated, they are usually excluded from the employer's pension and profit-sharing plan. There is currently no provision for a conduit IRA that allows them to transfer any rare coins that may be part of this plan. The result is that the item *must* be liquidated—regardless of whether such liquidation is to the employee's benefit or detriment at that time. The only alternative—accepting the distribution in its rare coin form—renders this a taxable event. This is obviously an inequitable and unintended result.

Benefits of S. 1405

S. 1405 simply restores rare coins to the menu of options for investors and allows them to diversify and stabilize their retirement portfolios. It would also allow these products to be rolled over from one plan to the employee's conduit IRA or new plan.

Important Provisions of S.1405

- Investment coins purchased for individually-directed retirement accounts must be in the possession of a qualified, third-party trustee (as defined by the IRS), *not* the investor.
- Coins eligible for inclusion in an individually-directed retirement account must be certified by a recognized third-party grading service, i.e., graded and encapsulated in a sealed plastic case. Each coin, therefore, has a unique identification number, grade, description, and bar code.
- Only those coins that trade on recognized national electronic exchanges or that are listed by a recognized wholesale reporting service are eligible for inclusion.

Recent Action Taken by the US Congress and the States

The Taxpayer Relief Act of 1997 restored certain precious metals bullion as qualified investments for IRAs. This was the first step in a two-step process. The restoration of certain certified coins will complete the restoration of these important products as acceptable for individually-directed retirement accounts.

The Joint Committee on Taxation has concluded that the inclusion of rare coins would have negligible economic impact on federal revenues.

There is broad, bipartisan support for the inclusion of rare coins as qualified investments in individually-directed retirement accounts, led by Senator John Breaux.

The independent study* done for the Joint Committee on Taxation found that the inclusion of rare coins and bullion in a diversified portfolio of stocks and bonds in-

***An Economic Analysis of Allowing Legal Tender Coinage and Precious Metals as Qualified Investments in Individually-Directed Retirement Accounts* by Raymond E. Lombra, Professor Economics, Pennsylvania State University, February, 1995; updated April, 2001. Available from ICTA, PO Box 1365, Severna Park, MD 21146–8365; telephone 410–626–7005; e-mail *ictaonline.org* creased the portfolio's overall return at the same time that it reduced risk. By purchasing rare coins in their IRAs, investors are able to keep tangible assets in their retirement plans over the long-term and, when they increase in value, sell them for a profit and reinvest the proceeds without having to immediately pay taxes on the gain.

Some of the conclusions of the study done for the Joint Committee on Taxation appear to have relevance to current economic conditions. The study reported that stocks and rare coins had the highest rates of return over a 20-year period and the statistical analyses reveal that rare coins are inversely related to stocks in a stock bear market (e.g., the collapse in stocks in 1987 triggered a major bull market in rare coins) but also, on occasion, are positively related to stocks during stock bull markets (e.g., the recovery in stocks after the '87 crash did nothing to slow the bull market in rare coins). For the majority of the period analyzed, the study showed that rare coins did best when bear markets in stocks sent investors looking for alternative investments.

Twenty-six states have exempted coins and precious metals from sales tax because they recognize them to be investment products. In seven additional states, such exemption legislation is under consideration.

We believe that this legislation is consistent with Congress' desire to encourage U.S. citizens to save/invest more and to take personal responsibility for retirement. In addition, tangible assets are real, not paper, investments that will never lose their intrinsic value and which maintain an orderly, easily-transacted, and portable marketplace. They provide today's investors with security for the future just as they have for thousands of years.

Statement of the International Mass Retail Association, Arlington, Virginia

The International Mass Retail Association (IMRA) is the world's leading alliance of retailers and their product and service suppliers—IMRA speaks for the trillion-dollar mass retail industry in Washington. American consumers prefer mass retailers to all other shopping options for the unmatched price, value and convenience they offer. Mass retailers have revolutionized the way America shops, re-engineered the global supply chain and redefined relationships between sellers and suppliers. Today, mass retailers create markets for consumer products here at home and around the world. Mass retailers are also some of the largest employers in America, creating millions of good jobs for hard working people of all skill levels. Many mass retailers provide comprehensive retirement savings options and profit sharing opportunities to most of their employees.

As Congress looks into the retirement savings losses suffered by Enron employees as a result of the company's bankruptcy and reviews whether reforms are needed to protect employees' savings, the member companies of IMRA urge you to take a careful and measured approach to any legislative changes. We applaud you for beginning that important deliberative process by holding today's hearing.

The Importance Of Retirement Savings

American workers have come to realize that company-sponsored pensions, 401(k) and other deferred compensation plans, and profit sharing and stock ownership plans, are important supplements to Social Security to help them maintain a comfortable standard of living during their retirement years. The mass retail industry appreciates the important role these additional retirement savings tools play and many mass retail companies offer retirement savings plans and profit sharing opportunities to most employees—including hourly, part-time employees.

Some Proposed Legislative Changes Could Hurt Retirement Savings

While it is certainly no one's intention to change pension and retirement savings laws in a way that would deter companies from offering these important benefits to their employees, IMRA is concerned that some of the proposals could have that unintended effect. We urge members of Congress to listen to the business community when we say that certain proposals could cause employers to discontinue offering these very successful, but wholly voluntary benefits to employees. Mass retailers that provide retirement benefits understand that such savings plans are a good arrangement for employees and that they help our industry attract and retain high-quality employees. If these benefits become too expensive, mass retailers—companies that operate on extremely thin profit margins—might have no alternative but to scale back or eliminate benefits.

Employee Stock Ownership Plans (ESOPs)

Some mass retailers have established ESOPs as a vehicle to hold employer contributions of stock. ESOPs offered by mass retailers are often available to most employees, including part-time, hourly employees. The mass retail industry can suffer from a high turnover of employees, yet mass retailers prefer to retain skilled employees, as knowledge of the stores and the products they sell is important to providing top-notch customer service. Mass retail companies that provide profit sharing offer employees an incentive to remain with the company and give employees an ownership stake in and pride in the company. Employees with an ownership stake in their company have a strong incentive to reduce waste and promote efficiency, which is so important to the mission of mass retailers: providing high-quality products at low prices with first-rate customer service. A study available from the National Center for Employee Ownership shows "unambiguous evidence that broad-based stock option companies had statistically significantly higher productivity levels and annual growth rates compared to non-broad-based stock option companies."[1]

Proposals that would require diversification of ESOP holdings after as little as five years would change the fundamental nature of ESOPs and would cause serious administrative problems. ESOPs were designed to facilitate employee ownership of companies, but requiring diversification frustrates that goal by mandating investment in vehicles other than, or in addition to, company stock. Also, requiring diversification after as little as five years (regardless of a participant's age) would cause great administrative problems, particularly for accounts of lower-wage or part-time employees that can hold less than $5,000 even after five years in the program. Requiring diversification of accounts holding such relatively small amounts would create an administrative burden out of proportion to the account balance, causing companies to rethink whether giving such profit sharing opportunities to a broad group of employees is cost-effective.

401(k) Plans Combined with ESOPs (KSOPs)

Some mass retailers, like other companies, have combined their 401(k) plan with their ESOP. Companies that use these so-called "KSOPs" use ESOP contributions to match employees' contributions to the 401(k) plan. Companies benefit from such an arrangement because the employer contributions help avoid violating the anti-discrimination rules (by attracting lower-wage employees into the plan) and because it provides an attractive vehicle for giving employees company stock, and thereby obtaining the benefits of ownership and pride in the company, described above. Employees benefit because the employer match is, essentially, free stock in their company, and because it provides a tremendous incentive for employees to participate in their retirement savings plan. Employer ESOP contributions to match 401(k) contributions are tested as 401(k) matches, which makes them attractive to the company; they are still tested, but do not have to go through the additional ESOP allocation rules. Companies see a benefit in matching employee contributions because it helps them attract employees, and it helps employees save for their retirement. If Congress removes the KSOP matching option, some companies may choose to match in cash, but many others may not; and if they cannot satisfy the anti-discrimination rules, they may not be able to offer a retirement savings vehicle to their rank-and-file employees.

Holding Period Limitations

Like a lot of companies, many mass retailers match employee contributions to retirement savings plans—such as 401(k) plans—with either company stock or cash that the employee can invest in one of several investment options. Similarly, many employers provide non-elective contributions of employer stock. Employers may match in employer stock to give employees an ownership stake in the company and because it is less costly than matching in cash. Legislation that eliminates an employer's ability to restrict the sale of company stock given as a match or as a grant after an employee has a certain amount of time with a company frustrates the employer's purpose of giving the employee an ownership interest in the company. IMRA agrees that it is reasonable to place limits on the length of time an employer may restrict its stock given as a match, but we believe that employers must be able to place some reasonable restriction on the sale of each block of stock given to an employee. Without being able to require a reasonable holding period, employers might be deterred from giving company stock at all; and if they do not give company stock, they may decide to reduce or eliminate their match.

[1] Joseph Blasi, Douglas Kruse, James Sesil, Maya Kroumova, Public Companies with Broad-Based Stock Options: Corporate Performance from 1992–1997, available electronically at http://www.nceo.org/library/optionreport.html.

Percentage Caps on Employer Stock

While most mass retail company retirement plans hold only a small percentage overall of employer stock, some employees choose on their own to hold a significant percentage of their retirement savings in company stock. Plan participants that have had the benefits of diversification explained to them should be able to direct their investments as they choose. While the purported reason for such caps is to protect employees' savings should their employer goes out of business, in truth it is employees and their retirement savings that would be harmed by the caps. Caps would force plan participants to sell employer stock at a time when such a sale might be against their interests. Furthermore, percentage caps would cause problems for companies that match in employer stock, and could lead to fewer companies providing matching contributions.

Notifications, Periodic Plan Statements

Several legislative proposals call for quarterly statements for plan participants. While IMRA agrees that plan participants need information about their retirement savings investments, we urge Congress to consider that access to plan information can be made available in many forms, including electronic access. Indeed, some employer sponsored plans provide instant electronic access to individual accounts at all times of day or night, so requiring mailed quarterly statements, for example, is simply an unnecessary and costly government mandate.

Conclusion

Mass retailers strive to be good employers by providing a wide variety of retirement savings options for their employees. Millions of mass retail employees are saving for their retirements because their companies are able to offer them one or more retirement savings plans. Many employees are able to save even more for their retirements because their employers see a benefit in making non-matching contributions to their employees or matching their employees' retirement savings contributions, either in stock or in cash. Through these plans, many countless employees have had corporate ownership opened up to them; something that might not otherwise have been a possibility. As Congress contemplates how to make employer sponsored retirement savings plans operate better for employees, IMRA encourages you to make improvements that will help employees make sound decisions about their investment, but to avoid legislative changes that would only make it more costly for companies to offer these important, successful and voluntary plans for their employees.

Statement of the Investment Company Institute

The Investment Company Institute (the "Institute") [1] is pleased to submit this statement to the House Committee on Ways and Means with regard to retirement security issues and the rules that govern defined contribution plans. The U.S. mutual fund industry serves the retirement savings and other long-term financial needs of millions of individuals. By permitting individuals to pool their savings in a diversified fund that is professionally managed, mutual funds play an important financial management role for American households.

Mutual funds also function as an important investment medium for employer-sponsored retirement programs, including section 401(k) plans, 403(b) arrangements and the Savings Incentive Match Plan for Employees ("SIMPLE") used by small employers, as well as for individual savings vehicles such as the traditional and Roth IRAs. As of December 31, 2000, about $2.4 trillion in retirement assets, including $1.2 trillion in IRAs and $766 billion in 401(k) plans, were invested in mutual funds. This represented about 46 percent of all IRA assets and 43 percent of all 401(k) plan assets.[2] In addition, the mutual fund industry provides a full range of administrative services to employer-sponsored plans, including trust, recordkeeping, and participant education services.

---

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,040 open-end investment companies ("mutual funds"), 487 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.952 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] *Mutual Funds and the Retirement Market in 2000,* Fundamentals, Vol. 10, No. 2, Investment Company Institute (June 2001).

Retirement security is of vital importance to our nation's future. The Institute has long supported efforts to enhance retirement security for Americans, including efforts to encourage retirement savings through employer-sponsored plans and IRAs, simplify the rules applicable to retirement savings vehicles, and enable individuals to better understand and manage their retirement assets. Accordingly, in light of the Committee's inquiry and hearing on these important matters, we offer three recommendations.

First, we urge Congress to make permanent the crucial improvements made to our pension laws in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). As the Committee is aware, unless there is congressional action, the provisions of EGTRRA will expire on December 31, 2010.

Second, the Institute recommends that Congress simplify the rules governing retirement savings vehicles. In particular, we urge the repeal of the complex income eligibility rules applicable to IRAs—rules that effectively have deterred many eligible individuals from using these vehicles to save for retirement. The rules on required minimum distributions from retirement plans and the various rules that govern different types of defined contribution plans also should be simplified.

Finally, Congress should enhance participant access to professional investment advice with regard to their pension plan investments. The House has already acted decisively in passing H.R. 2269, the Retirement Security Advice Act, to expand the availability of advisory services to participants and beneficiaries. We urge swift enactment of this important legislation, which will provide individuals with the tools they need to appropriately invest their retirement assets.

I. A Shift in the Pension Landscape

The past few decades have witnessed a remarkable shift in the way Americans save for retirement. When the Employee Retirement Income Security Act (ERISA) was enacted in 1974, defined benefit plans were the primary private sector retirement vehicle for employees. Since the passage of that landmark legislation, defined contribution plans have grown to become an equally important medium through which workers save for retirement. From 1975 to 1998,[3] the number of participants in defined contribution plans nearly quintupled from 12 million to almost 58 million. The number of defined contribution plans tripled. In 1975, $74 billion was held in defined contribution plans; today, assets in defined contributions plans stand at about $2.3 trillion, of which $1.8 trillion is held in 401(k) plans.[4] At the individual participant level, 401(k) plan participants had an average account balance at their current employer of nearly $50,000 as of year-end 2000. Individuals in their 60s with at least 30 years tenure at their current employer had average account balances in excess of $177,000.[5]

Participant-directed defined contribution plans offer many features that are attractive to employees. First, the portability offered under defined contribution plans is well-suited to today's mobile workforce.[6] Participants in defined contribution plans are generally able to take their retirement assets with them and maintain their value as they move from job to job. The major tax legislation enacted last year—EGTRRA—has enhanced the portability of retirement assets, allowing rollovers between different types of retirement plans, such as 401(k) plans, 403(b) arrangements, government-sponsored 457 plans, and IRAs. The ability to do so enables individuals to consolidate, efficiently manage, and better preserve and enhance the value of their retirement savings.

Second, participants in self-directed defined contribution plans have greater control of their retirement investments. For instance, 401(k) participants have the ability to select from among an average of 12 investment alternatives;[7] the choice permitted in such plans stands in contrast to the traditional defined benefit plan model, under which plan sponsors or appointed investment managers exclusively

---

[3] The most recent data available from the Department of Labor is for 1998. *Private Pension Plan Bulletin, Abstract of 1998 Form 5500 Annual Reports,* U.S. Department of Labor, Pension and Welfare Benefits Administration (Winter 2001–2002).

[4] *Private Pension Plan Bulletin, Abstract of 1998 Form 5500 Annual Reports,* U.S. Department of Labor, Pension and Welfare Benefits Administration (Winter 2001–2002); Mutual Funds and the Retirement Market in 2000, Fundamentals, Vol. 10, No. 2, Investment Company Institute (June 2001).

[5] *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000,* Holden and VanDerhei, Perspective, Vol. 7, No. 5, Investment Company Institute (November 2001).

[6] *See Debunking the Retirement Myth: Lifetime Jobs Never Existed for Most Workers,* Issue Brief No. 197, Employee Benefit Research Institute (May 1998).

[7] 44th Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America (2001).

manage pension assets.[8] Furthermore, for participants that wish to minimize risk in their 401(k) accounts, most plans offer conservative investment options, such as guaranteed investment products, money market funds and fixed-income investment vehicles.

Third, individual account-based plans provide a visible, understandable account value. Concepts applicable to defined contribution plans such as salary deferral and employer matching contributions are straightforward and easy to understand. In particular, where mutual funds are offered as investment options in a 401(k) plan, investors are able to identify the accurate and current value of their accounts, as mutual fund shares are valued on a daily basis.

Despite the successes of participant-directed retirement plans, however, policymakers must remain vigilant to assure that our pension laws provide individuals with sufficient opportunities and incentives to save, clear and understandable rules that govern long-term savings vehicles, and the education and tools that enable them to make prudent decisions with regard to their retirement savings. Consistent with these objectives, the Institute offers the following recommendations.

II. Make Permanent the Retirement and Education Savings Provisions of EGTRRA

Last year, Congress made sweeping, long-awaited enhancements to our nation's pension laws by enacting EGTRRA. Among the numerous improvements made to the private retirement system, the legislation:

- increased the contribution limits to IRAs—limits that had not been increased (even for inflation) since 1981;
- increased the contribution limits to employer-sponsored retirement plans, such as 401(k) plans, 403(b) arrangements, governmental 457 plans, and defined benefit plans;
- provided for "catch-up" contributions to be made by individuals 50 and over to their pension plans and IRAs; and
- made retirement assets significantly more portable, especially among different types of retirement plans, such as 401(k) plans, 403(b) plans, 457 plans and IRAs.

The legislation also created additional long-term savings incentives for education savings vehicles such as Code section 529 qualified tuition programs and Coverdell education savings accounts (formerly education IRAs).[9]

A "sunset" provision, however, was included in EGTRRA for procedural reasons. Thus, all of these (and other important) changes made by EGTRRA will cease to apply after December 31, 2010. Clearly, the consequences of inaction on this issue would be detrimental to our retirement system. For individuals to plan appropriately for their retirement, they must be able to rely on predictable rules—rules that apply now and throughout one's career and retirement. The future termination of these provisions could affect the long-term savings strategies of working individuals, undermining the purpose of these pension reforms.

Accordingly, we urge Congress to eliminate the uncertainty by making permanent the retirement and education savings provisions of EGTRRA.

III. The Need for Simplification

For savings incentives to be effective, the rules need to be simple. Too often, however, frequent legislative changes and regulatory interpretations have led to complicated tax rules that are extremely difficult for taxpayers to understand. Furthermore, these complexities make retirement plan administration more difficult and create disincentives for plan formation. These considerations are also important to financial institutions when they assess whether to make long-term business commitments in the retirement savings market.

---

[8] The growth of the 401(k) and other self-directed retirement plans has also enabled a greater number of Americans to own equity investments. See Equity Ownership in America, Investment Company Institute and the Securities Industry Association (Fall 1999). For example, approximately 29 million households—representing 27.9 percent of U.S. households—and 39.9 million individuals owned stock mutual funds inside employer-sponsored retirement plans in 1999.

[9] EGTRRA provisions relating to 529 plans, among other things, (1) exclude distributions used for qualified higher education expenses from gross income, (2) replace the current state-imposed "more than de minimis penalty" on nonqualified distributions with a federal 10 percent tax, (3) permit rollovers of amounts between 529 programs for the same beneficiary, and (4) permit a change in designated beneficiary to "first cousins." With regard to Coverdell accounts, changes made by EGTRRA included an increase in the annual contribution limit from $500 per designated beneficiary to $2,000. These provisions generally became effective on January 1, 2002.

Such complexities are clearly evident in our nation's pension laws. Since the passage of the ERISA, there have been over a dozen major amendments to pension laws and the related tax code sections.[10] Many of these legislative changes—most recently, the retirement savings provisions in EGTRRA which were strongly supported by the Institute—have provided new savings opportunities by increasing contribution limits to employer-sponsored retirement plans and IRAs and creating new savings vehicles, including the Roth IRA, SIMPLE plans and 529 qualified tuition programs. Many amendments to our pension laws, however, also have added unnecessary complexity and administrative burdens that serve as disincentives to employers to sponsor retirement plans and to individuals to save for retirement. Easing these burdens will promote greater plan formation, coverage and overall retirement savings.

Last year, the Joint Committee on Taxation made a number of significant recommendations on the overall state of the federal tax system.[11] That study included a number of proposals to simplify the rules governing various retirement and education savings vehicles. The Institute reiterates the recommendations made with regard to the Joint Committee's report.[12] Here, we specifically focus our recommendations on the IRA eligibility rules, the required minimum distribution rules that apply to employer-sponsored plans and IRAs, and the divergent rules that govern different types of defined contribution plans.

A. IRA Eligibility Rules

As the Joint Committee recommended in its report last year, the Institute requests that Congress simplify the rules governing IRAs by eliminating the phase-out income eligibility restrictions for IRA contributions and eliminating the income limits on the eligibility to make deductible IRA contributions. Such simplification would address an important need: the current IRA eligibility rules are so complicated that even individuals eligible to make deductible IRA contributions are often deterred from doing so.

When Congress imposed the current income-based eligibility criteria in 1986, IRA participation declined dramatically—even among those who remained eligible for the program. At the peak of IRA contributions in 1986, contributions totaled approximately $38 billion and about 29 percent of all families with a household under age 65 had IRA accounts. Moreover, 75 percent of all IRA contributions were from families with annual incomes of less than $50,000.[13] However, when Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and never recovered—down to $14 billion in 1987 and $8.2 billion in 1998.[14] Even among families retaining eligibility to fully deduct IRA contributions, IRA participation declined on average by 40 percent between 1986 and 1987, despite the fact that the change in law did not affect them.[15] The number of IRA contributors with income of less than $25,000 dropped by 30 percent in that one year.[16]

Surveys by mutual fund companies also show that about fifteen years later, many individuals continue to be confused by the IRA eligibility rules. For example, in 1999, American Century Investments surveyed 753 self-described retirement savers about the rules governing IRAs. The survey found that changes in eligibility, contribution levels, and tax deductibility have left a majority of retirement investors

[10] Since 1994 alone, Congress has passed five substantial pieces of pension-related tax legislation: the Uruguay Round Agreements Act of 1994, the Uniform Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and EGTRRA in 2001.

[11] See Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, JCS–3–01, Joint Committee on Taxation (April 2001).

[12] See Statement of the Investment Company Institute for the Hearing on Tax Code Simplification submitted to the House Committee on Ways and Means, Subcommittee on Oversight and Subcommittee on Select Revenue Measures (July 31, 2001); Statement of the Investment Company Institute submitted to the Senate Finance Committee on the Study of the Overall State of the Federal Tax System and Recommendation for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (May 7, 2001).

[13] Promoting Savings for Retirement Security, Stephen F. Venti, Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

[14] Internal Revenue Service, Statistics of Income.

[15] Promoting Savings for Retirement Security, Stephen F. Venti, Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

[16] Internal Revenue Service, Statistics of Income.

confused.[17] This confusion is an important reason behind the decline in contributions to IRAs from its peak in 1986. For these reasons, the Institute strongly supports a repeal of the IRA's complex eligibility rules, which serve to deter lower and moderate-income individuals from participating in the program.[18]

B. Required Minimum Distribution Rules

The Institute also supports efforts to simplify the required minimum distribution (RMD) rules applicable to retirement plans and IRAs. Under these complex rules, plan participants and IRA owners are generally required to take RMDs from their plans and IRAs after reaching age 70½. While the Institute generally supports the substantial steps toward simplification taken in the proposed regulations issued by the IRS last year,[19] we believe that additional reforms could be made to further mitigate the complexity of the rules.

The Joint Committee on Taxation suggested various changes intended to simplify the RMD rules. Specifically, the Joint Committee recommended that: (1) no distribution should be required during the life of a participant; (2) if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity should govern distributions after the participant's death; and (3) if distributions either do not commence during the participant's lifetime or commence during the participant's lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant's beneficiary or beneficiaries within five years of the participant's death.

While we have concerns about the unintended consequences of some of these recommendations,[20] the Institute supports the Joint Committee's efforts to build upon the simplification achieved by the new IRS proposed regulations. We would be pleased to work with members of the Committee on Ways and Means and the Joint Committee to develop legislative proposals that will make the RMD rules more understandable and less burdensome to taxpayers.

C. Simplifying the Rules for Defined Contribution Plans

Employer-sponsored pension plans are a fundamental component of America's retirement system. As is the case with IRAs, however, the complexity of the rules applicable to employer-sponsored plans frequently deters employers from establishing pension plans and workers from taking advantage of them. By simplifying these rules, Congress would undoubtedly encourage retirement savings.

A wide variety of retirement plans exists. Under the category of defined contribution plans, there are a number of plan types, including 401(k) plans, 403(b) plans and 457 plans, each with its own set of rules. As the divergent rules and plan types often confuse working Americans and employers, the Institute urges Congress to reduce the complexity associated with these retirement plans. The ability of employees to understand the differences among plan types has become even more important as a result of the enactment of the portability provisions of EGTRRA.[21] As noted above, these provisions enhance the ability of American workers to take their retirement plan assets to their new employer when they change jobs by facilitating the portability of benefits among different types of arrangements, such as 401(k)s, 403(b)s, 457s and IRAs. The Institute strongly supports efforts by Congress to simplify and conform rules that apply to different plan types in order to increase employee understanding and encourage plan formation and coverage.

IV. Enhance the Availability of Professional Investment Advice

Because participants in self-directed retirement plans like the 401(k) are responsible for directing their own investments, it is critical that they have access to information, education and advice that will enable them to prudently invest and diver-

[17] American Century Investments, as part of its "1999 IRA Test," asked 753 self-described retirement "savers" ten general questions regarding IRAs. Only 30% of the respondents correctly answered six or more of the test's ten questions. Not a single test participant was able to answer all ten questions correctly.

[18] We note that the return of the universal IRA, coupled with the availability of the Roth IRA, would eliminate the need for the nondeductible IRA—thus, further simplifying the IRA rules. However, should Congress retain the income eligibility limits for either the traditional IRA or Roth IRA, the nondeductible IRA would continue to serve a critical objective—enabling those individuals not eligible for a deductible or Roth IRA to save for retirement. Thus, the nondeductible IRA should be eliminated only if Congress repeals the income limits for traditional and Roth IRAs.

[19] See 2001–11 I.R.B. 865 (March 12, 2001).

[20] For example, a rule requiring distribution of an entire account balance subject to the RMD rules within five years of the participant's death could result in harsh tax consequences for the participant's beneficiaries.

[21] See, e.g., sections 641 and 642 of EGTRRA.

sify their retirement savings. We, therefore, are pleased that the House has passed H.R. 2269, the Retirement Security Advice Act, and hope that the legislation will be enacted into law this year. This legislation, which has also been incorporated into the President's pension reform package, will help equip participants to appropriately invest their retirement assets, while imposing stringent participant protections that would require investment advisers to act solely in the interests of participants and beneficiaries.[22]

A. Current Law Restricts the Delivery of Advisory Services

Many retirement plan participants who direct their own account investments seek investment advice when selecting investments in their plans. Today's pension laws, however, significantly and unnecessarily limit the availability of investment advice. Indeed, ERISA severely limits participants' access to advice from the very institutions with the most relevant expertise and with whom participants are most familiar. As a result, only about *16 percent* of 401(k) participants have an investment advisory service available to them through their retirement plan.[23] By contrast, more than half of "retail" mutual fund shareholders outside of the retirement plan context have used a professional adviser when making investment decisions.[24] Clearly, existing rules have stifled access to professional investment advice to the detriment of plan participants.

The reason that many retirement plan participants do not have access to investment advice is that ERISA's prohibited transaction rules prohibit participants from receiving advice from the financial institution managing their plan's investment options. This is often the same institution that is already providing educational services to participants.[25]

Under ERISA, persons who provide investment advice cannot do so with respect to investment options for which they or an affiliate provide investment management services or from which they otherwise receive compensation.[26] The restriction applies even if the adviser assumes the strict fiduciary obligations under ERISA—which, among other things, require them to act "solely in the interest of participants and beneficiaries"—and even if an employer selects the investment adviser and monitors the advisory services in accordance with its own fiduciary obligations. Indeed, the *per se* prohibition applies no matter how prudent and appropriate the advice, how objective the investment methodology used, or how much disclosure is provided to participants.[27]

Because of current legal constraints, the investment advisory services available to plan participants have largely been limited to "third-party" advice providers. Notwithstanding the presence of these third-party advice providers, however, relatively few 401(k) plan participants have investment advisory services available to them through their retirement plans. The Department's recent advisory opinion issued to SunAmerica[28] on the provision of advice did little to rectify this problem. The ruling essentially reiterates preexisting restrictions on the provision of investment advice to plan participants—restrictions that limit participants to third-party advice providers. Indeed, in a statement issued contemporaneously with the advisory opinion, Assistant Secretary of Labor Ann Combs expressed strong support for H.R. 2269.

[22] See section 404 of ERISA, which sets forth the stringent duties of ERISA fiduciaries.

[23] 401(k) Participant Attitudes and Behavior—2000, Spectrem Group (2001). With respect to internet-based advisory services—the method by which most third-party advisers provide investment advice—a Deloitte & Touche survey found that only 18% of mid-size to large employers with 401(k) plans offered web-based advice to their employees. 2000 Annual 401(k) Benchmarking Survey, Deloitte & Touche (2000).

[24] Understanding Shareholders' Use of Information and Advisers, Investment Company Institute (Spring 1997).

[25] Current Department of Labor guidance permits plan service providers to provide "educational" services, but not give actual "investment advice" without violating the per se prohibited transaction rules of ERISA. See Interpretative Bulletin 96–1, in which the Department of Labor specified activities that constitute the provision of investment "education" rather than "advice."

[26] See generally section 406 of ERISA for the prohibited transaction rules.

[27] Although the Department of Labor is authorized to provide exemptive relief from these rules, the limited exemptions issued by the Department to certain financial institutions have proven to be wholly inadequate, as they have included conditions that act as de facto prohibitions on the ability of these firms to provide advisory services to plan participants. For example, under one approach adopted by the Department, advice may be provided if the institution agrees to a "leveling of fees" it or an affiliate receives from each investment option in the 401(k) plan. This makes little economic sense, however, because advisory fees for various investment options may differ widely from one fund to another, given that the underlying costs differ for each, depending on the type of investments the fund is making.

[28] Department of Labor Advisory Opinion 2001–09A.

Clearly, the availability of advice from third-party providers has *not* sufficiently addressed participants' needs.

B. The Retirement Security Advice Act

Recognizing this important public policy concern, the House of Representatives passed H.R. 2269, the Retirement Security Advice Act, last November by a vote of 280 to 144. The Administration has also incorporated H.R. 2269 in its broad pension reform proposal.[29]

H.R. 2269 would expand and enhance the investment advisory services available to participants. In particular, the legislation would allow advice to be obtained from the institutions most likely to be looked to for such services by participants and employers—the financial institutions already providing investment options to their plans. Participants, therefore, would be able to select their plans' providers for advisory services, in addition to third-party advice providers. Similarly, employers would be permitted to arrange for investment advice through a provider with which they are familiar, thereby eliminating the costs and burdens associated with selecting a separate vendor.

H.R. 2269 would enable pension plan participants to access sound investment advice from qualified financial institutions already known to them, while maintaining strict requirements to assure that they are protected from imprudent and self-interested actors. These requirements include subjecting advice providers to strict fiduciary standards under ERISA and extensive disclosures of any potential conflicts of interest to participants.

First, only specifically identified, qualified entities already largely regulated under federal or state laws would qualify as "fiduciary advisers" permitted to deliver advice to participants under the bill.

Second, such advisers would have to assume fiduciary status under the stringent standards for fiduciary conduct set forth in ERISA. This, among other things, would require them to act solely in the interests of plan participants and beneficiaries. These protections would shield participants from imprudent or self-interested advice.

Third, employers, in their capacities as plan fiduciaries, would be responsible for prudently selecting and periodically reviewing any advice provider they choose to make available to their plan participants. Thus, participants would be afforded an additional layer of protection by virtue of the employer's responsibilities as a plan fiduciary.

Fourth, the legislation would establish an extensive disclosure regime. Specifically, the "fiduciary adviser" would have to provide timely, clear and conspicuous disclosures to participants that identify any potential conflicts of interest, including any compensation the fiduciary adviser or any of its affiliates would receive in connection with the provision of advice. Additionally, any disclosures required under securities laws, which apply to similar advice provided outside of the retirement plan context, also must be provided to participants. It is important to note that these disclosure requirements would be in addition to the safeguards discussed above. The bill does *not* rely on disclosure alone to protect participants; rather, it includes disclosure as part of a broad panoply of protections.

Fifth, any advice provided could be implemented only at the direction of the advice recipient. Participants, therefore, would be free to reject any advice for any reason.

Finally, plan participants would have legal recourse available if a fiduciary adviser violates the standards set forth in the bill or ERISA. For instance, under section 502 of ERISA, a plan or participant could seek relief in federal district court to redress the adviser's violation of its fiduciary duties. Similarly, the Department of Labor has authority under ERISA section 502 to file suit against a fiduciary adviser in violation of ERISA and take regulatory enforcement action, including the assessment of civil penalties for any breach of fiduciary duty.

The participant-protective safeguards and the overall approach of H.R. 2269 stand in stark contrast to an alternative proposal introduced by Senator Bingaman—S. 1677, the Independent Investment Advice Act of 2001. That bill would *not* expand the types of advisers that may provide investment advice to participants; rather, it would only provide fiduciary relief to *employers* when selecting and monitoring an investment adviser to provide advice to participants. Under S. 1677, participants largely would be limited to the advisory services of third party advice providers al-

[29] See H.R. 3762, introduced by Representatives Boehner, Johnson and Fletcher (February 14, 2002); S. 1921, introduced by Senators Hutchison, Lott and Craig (February 7, 2002); S. 1969, introduced by Senators Hutchinson, Gregg and Lott (February 28, 2002).

ready allowed under current law—which, as noted above, effectively has restricted the availability of investment advice to a small percentage of participants.

In short, there is little question that many plan participants seek and are in need of professional advice. H.R. 2269 would greatly expand the availability of these advisory services, while maintaining rigorous protections against parties that fail to serve participants' interests. We urge Congress to enact this important legislation.

V. Conclusion

Improving and maintaining savings incentives, simplifying the rules governing retirement savings vehicles, and empowering individuals with the education and professional advice they seek will promote greater retirement savings and security for all Americans. The Institute, therefore, urges Congress to advance these objectives by enacting the foregoing recommendations.

Statement of the Pension Reform Action Committee

PRIVATE COMPANIES AND THEIR EMPLOYEES' RETIREMENT SAVINGS FACE UNIQUE CONCERNS IN PENSION REFORM

- Thousands of non-public companies across America are employee-owned. These companies, the vast majority of which are small—and medium-sized and/or family businesses, are a hallmark of American entrepreneurship. Through their growth, they have helped fuel the national economy by providing increasing numbers of jobs for millions of workers in fields ranging from trucking to tourism, from manufacturing to management consulting.
- Private, employee-owned companies also have unique concerns that must be considered in the context of the current debate over proposed pension reforms. In particular, as described below, proposals to change existing diversification rules for non-publicly traded stock would harm, not enhance, the retirement savings of the employee-owners of these companies.
- Two particular features distinguish private from public business: First, the stock of a private business cannot be sold on the public market. Thus, when company stock is sold, the only purchaser of the shares is the company itself. Any change to current law that facilitates substantial sales of private company stock will place an enormous strain on the capital of the company-buyer, potentially forcing up leverage ratios and reducing the company's ability to fund ongoing operations/growth.
- The second, related distinction is that a private company's stock value does not derive from the public markets, but rather from a private valuation of the company's assets, liabilities and cash flow. Any change to current law that facilitates the sale by employees of large amounts of private company stock—regardless of whether the employees choose to divest of these shares—creates a massive contingent liability for the company-buyer. The automatic result of this liability is that the company's stock value will fall, resulting in a devaluation of the employees' stock accounts.
- It is also important to understand that among private, employee-owned companies there is a standard culture of entrepreneurship and personal economic empowerment. Private employee-owned companies are typically "open book" companies, where employees are informed investors in the company. Furthermore, in the vast majority of cases, these employees reap enormous benefits from their piece of the rock in their company—setting aside more retirement savings in their ESOP accounts, for example, than they could ever amass in a 401k plan or other retirement program.
- In summary, private companies are uniquely vulnerable to proposals that would alter existing pension laws on mandatory diversification, and any such changes would impair the retirement savings of employee-owners of these businesses.
- To date, only one pension reform bill that has been introduced—the Portman/Cardin bill—to exempt private companies from new mandatory diversification rules. It is critical to the viability of these companies, and the health of the retirement savings of their employees, that in any new pension reforms, this distinction survive.